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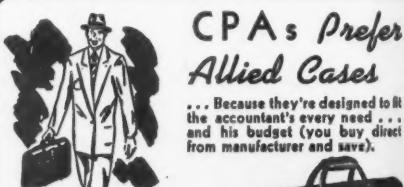
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BOOK REVIEWS

College and University Business Administration (Vol. I).

Compiled by The National Committee on the Preparation of a Manual on College and University Business Administration. AMERICAN COUNCIL ON EDUCATION, Washington, D. C., 1952. Pages: xiii + 217; \$4.50.

The committee responsible for the compilation of the contents of this volume comprised many individuals well known in college and university business circles. A committee of the American Institute of Accountants was appointed to cooperate on this project and three of these (Ralph S. Johns, Marcus Robbins and Howard A. Withey) are members of our Society.

This is the first of a two-volume series relating to college and university business administration. It is a revision of the earlier publication "Financial Reports for Colleges and Universities", issued in 1935, which has been out of print for many years. It embraces the accounting features of administration.

The present volume elaborates on the basic principles expounded in the 1935 publication and treats many new problems developed in the intervening years; notably the impact of accounting requirements in connection with research and development contracts with various agencies of the Federal Government. There are several features of outstanding value to professional accountants as well as college and university administrators. Among these may be mentioned: the statement of basic principles applicable to college and university accounting; audits; procedures for the allocation of indirect expenditures; the appendix on terminology; the exceedingly useful bibliography; and the suggested forms.

Many controversial matters are dealt with rather completely such as "Depreciation of Real Property", "Budgets and Budgetary Accounting", and the "Unit Cost" problem.

As with any volume of this kind there are always recommendations to be found which invite speculation, for example the statement: "Funds accumulated for the retirement of debt incurred for plant acquisition should also be reported in a separately balanced section of this (Plant fund) fund group." This would seem to create an inflation of the plant fund section by including an item of a strictly financial nature. Consideration should be given (and perhaps it was) to placing this retirement fund in the reserve section.

Also, one might be led to the conclusion from the chapter on "Budgets and Budgetary Accounting" that a superior control over appropriations will result from the double bookkeeping arising from entering the appropriations and estimated income in the general

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BOOK REVIEWS

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ledger along with the actual receipts and payments. Frequent budgetary adjustments would call for entries in the general ledger for appropriation changes and these combined with postings of realized actual receipts and expenditures would seem to promote confusion in the recording division. The entering of encumbrances in the form of requisitions or purchase orders as recommended would seem to add a further element of confusion, not to mention the vast expense involved in formally recording all this mass of data. That this expense element is recognized is evident from the admission, "Some institutions may not desire to maintain budget control accounts on the books because of the labor and expense involved in so doing." The assertion is made that "the results to be obtained by carrying budget control accounts in the general ledger and by applying encumbrances against the balance available for expenditure are valuable; and while such information may be obtained in other ways, the results usually are less satisfactory." The implication is that the same information as to the appropriations and encumbrances obtained from memorandum records is less reliable. This claim is debatable. The use of punched card accounting now is not uncommon among educational institutions and budget appropriation cards prepared from a budget ledger maintained on an informal basis can be combined with cards punched from actual transactions, plus cards for encumbrances punched at the end of each month, likewise from informal records, to produce statements of the condition of appropriations quickly, accurately and relatively inexpensively. The memorandum records are always up-to-date every day. The same procedure may be applied where manually kept records still are in use. The importance of budgetary control should not, however, be minimized by this comment on the effectiveness of formal as opposed to informal methods of recording.

The suggestion is also made in connection with prepaid expenses that "many items, such as insurance premiums, which appear frequently as prepaid expense or deferred charges in the accounts of commercial organizations, need not be prorated in institutional accounting." This recommendation is permissive and hence subject to interpretation. If the institution has its coverage on a "five year plan" in which 1/5 of the premiums fall due each year this might be workable. This is too utopian and the unexpired value of premiums, paid in advance in many institutions is a figure so material that it could not be disregarded in preparing the balance sheet.

The committee's rather free use of the

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BOOK REVIEWS

(Continued from page 102)

term "surplus" in the pages relating to "Balance Sheet and Supporting Statements" fails to recognize the efforts of the accounting profession over the past few years to escape from the public misunderstanding of the term and to develop other expressions to describe this equity feature of double entry bookkeeping. In the light of the continual pleading of financial difficulty by educational institutions, the use of the term "surplus" would seem to refute their plea. It should be avoided not only because modern accounting advocates the idea but because it implies wealth instead of poverty.

With reference to expenditure from current funds for additions to physical plant the committee makes the recommendation, "However it is preferable to make such transfers directly from surplus and to report them in the summary of changes in surplus." The profession has generally taken the position that the income statement should be all inclusive and accordingly the prior expression of the committee in discussing the income statement would seem to be more in keeping with current thinking. It reads "An additional category, Transfers and Appropriations, may be used to report appropriations of current funds to other fund groups. When this category is used, a clearly designated Total of Current Expenditures should be shown on the statement above the item for Transfers and Appropriations."

These observations direct attention to a few thoughts developed during a reading of the publication. It is an exceedingly well organized manual, the recommendations are those of a distinguished and capable group, and the book is a reliable guide to the best practices in this field of college and university business administration.

It is highly recommended for inclusion in the library of all firms having relations with colleges and universities. It will also be useful to firms who have engagements with hospitals, church bodies, charitable foundations, institutions for the aged, infirm, blind, etc. to which "fund accounting" procedures apply.

EARLE L. WASHBURN

New York University
New York, N. Y.

A Dictionary for Accountants

By Eric L. Kohler, PRENTICE-HALL, INC., New York, N. Y., 1952. Pages: x + 453; \$7.50.

The author has rendered a signal service to the accounting profession in gathering into one book definitions of virtually every accounting term used. Some of the expressions probably have not been defined before, others would require a good deal of search through many books to locate. Here they are all in one book.

(Continued on page 107)

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BOOK REVIEWS

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Further, the author has collected for accountants definitions of terms used by other professions and businesses with which they often come into contact. Pertinent phraseology used by bankers and other credit executives, engineers, economists, lawyers, statisticians, insurance executives, and others is explained.

An accountant should now be able to quickly determine what is meant by C&F CIF, and FAS, the terminology used to denote billing terms in import and export trades. The banker's and credit executive's phrases "above the line" and "below the line" are explained for the accountant who hears them for the first time. Illustrations of just a few of the many other expressions used by others, and as to which the accountant may have to be informed are: 'blotter', 'bill of exchange', 'bailment', 'hedge', 'index number', 'logarithm', 'parity price', 'prospectus', 'revenue bond', 'retrospective rating', and 'cremation certificate'.

The author also renders a very valuable service to those who deal with accountants or have occasion to read accountants' reports. Those who are mystified by, or uninformed as to terms such as accrual, contingent lia-

bility, accounting principles, depreciation, surplus, balance sheet, etc., will find explanations of these and many other accounting expressions that are commonly misunderstood or misapplied. Practicing accountants and students may also find it helpful to scan the explanation of an accounting term which they may not have heard before, or as to the meaning of which they are in doubt.

One will find more than definitions of words and phrases; some subjects have received fairly complete though concise treatment. For example, there is an explanation of 'consolidation policy', an extensive discussion of 'accounting principles', and virtually a treatise on the various depreciation policies in effect under the caption 'depreciation method.' Source material is freely quoted to aid in further research where desired; and forms are submitted as illustrations where helpful.

There are 2275 terms in this dictionary. Certain of the explanations are very concise, others are extensive, covering several pages. Some of the material dealing with non-accounting items is excessively technical and appears not to have been written for account-

(Continued on page 108)

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BOOK REVIEWS

(Continued from page 107)

ants particularly. However, the author in his foreword very frankly points out that the first edition of his dictionary is a tentative one and that it undoubtedly has its shortcomings. The treatment of the non-accounting material is one of the conditions which could eventually be improved.

The dictionary does not displace any books on accounting subjects. It is merely a convenience to accounting practitioners and students, and to other professionals and business executives, that makes it possible for them to easily obtain authoritative, condensed explanations of accounting terms and expressions. Moreover, the accountant can readily ascertain the meaning of phrases common to others, which concern him. It is a desirable addition to every accounting office and library, and even the first edition will have lasting value.

MAX BLOCK

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Accounting for Inflation

A study of techniques under conditions of changing price levels. By the Taxation and Research Committee of The Association of Certified and Corporate Accountants. GEE AND COMPANY (PUBLISHERS) LIMITED, London, E.C. 2, 1952. Pages: 149; post free (abroad) 15/10.

This book considers the problem of the adequacy of the existing accounting treatment of the depreciation of fixed assets and of the valuation of merchandise inventories under inflationary conditions.

Chapter I discusses current practice with respect to (1) depreciation as a cost and (2) inventory pricing and valuation. Tax implications are stated; also, the effects upon the financing of replacements and on the interpretive value of the accounts. Chapter II examines more closely into the financial problem in its statistical setting. Chapter III restates the orthodox position, as well as its underlying theoretical basis.

In Chapter IV, the authors review several viewpoints on the replacement cost approach (anticipated cost, purchasing power, and current cost) as a basis for the subsequent presentation of their methodology with respect to fixed assets (Chapter V) and inventories (Chapter VI). The outlined technique is then evaluated by them in Chapter VII.

An Appendix describes the current situation in eight countries, including the United States, with respect to the effect of inflation on accounting techniques and company (corporate) taxation. A select bibliography completes the work.

This most interesting treatise is a very valuable contribution to the current literature on this important problem.

THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL Saxe, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

VOL. XXIII

February • 1953

No. 2

Financial Statements for Life Insurance Companies

By EDWARD J. MALLON, C.P.A.

This paper indicates certain peculiarities in life insurance accounting, as distinguished from commercial accounting. It also summarizes the changes recently made in the annual statement required to be filed by all life insurance companies.

Starting last year, 1951, every life insurance company licensed to do business in the United States had to report its operation for the year and its status as of December 31 on a new form of statement prescribed by governing authorities. This changeover was rather remarkable for a number of reasons.

1. The new form of statement did not create even a ripple in accounting circles although the industry of life in-

surance represents assets of over \$68 billion and insurance protection of over \$253 billion.¹

2. The regulations came not from a single governing authority but they came from each of the 48 states and the District of Columbia.

3. The new form of statement is a radical change from the form used by the reporting life insurance companies for the preceding seventy-five years. Strangely enough the contents of the form were altered very slightly in the transition.

An explanation of the first two points and an exposition of the statement to clear the third point may be of interest to the readers. The interest should be aroused not only because of the accounting involved but also because each reader probably owns a life insurance policy. Furthermore if the policy is issued by a mutual company, then the reader is a part owner of that life insurance company.

EDWARD J. MALLON, C.P.A. is a member of the Committee on Insurance and Agency Accounting of the New York State Society of CPA's. He is a graduate of Fordham University (B.S.) and City College (M.B.A.), and has taken graduate courses at Duke University in government fiscal accounting. He teaches accounting at Pace College and is the assistant controller of The Guardian Life Insurance Company of America.

¹ Life Insurance Fact Book 1952, Institute of Life Insurance.

Accounting Personnel

Noted as point number one was the almost complete lack of interest on the part of the accounting profession. The main reason for this is that only a small minority of accountants ever have an opportunity to participate in an examination of a life insurance company. This is not to say that public accountants are not employed by the companies. They are. The extent of such employment varies extremely from company to company. Some companies never have outside auditors; reliance is wholly on their own internal auditors, if any, and the examinations of the states' insurance departments. Going back a number of years to the hearings before the Temporary National Economic Committee, it was determined that half of the twenty-six largest life insurance companies in the United States never engaged independent public accountants.² Other companies not only engage public accountants, but in at least one company the accountants are selected by a committee of policyholders.

In a great many companies, especially here in the east, the general direction of the accounting of the companies and the preparation of accounting statements is by an actuary and not by an accountant. The reason for this situation and the lack of outside public auditors is partly historical. Sometimes it is forgotten that the professional status of accountants in the United States is of comparatively recent growth. Years ago when accounting had to be done or statements had to be prepared, it was logical to place the responsibility under the direction of someone who understood figures. That person certainly was the actuary as far as life insurance companies were concerned. In many companies this situation has continued. This is not true in all companies. Some companies have trained accountants or actuaries turned

accountants. Even where the direction of accounting is under actuarial control, the supervising actuary, of necessity, has learned accounting at least as far as life insurance is concerned. Such an actuary probably soon discovers that he must devote his full attention either to his actuarial or accounting functions. Not only is it difficult to span two professions but more and more specialization within a profession seems required.

Another reason, other than historical, for the comparatively few trained accountants doing the accounting in life insurance companies is the type of liabilities that life insurance companies have. The bulk of the liabilities consists of "reserves" for which actuarial calculations are required. This term "reserves" will be explained later as it has a meaning quite distinct from the meaning in commercial accounting which indeed is varied enough. This reason which is persuasive seems to be the least valid of all. Accountants, whether public or private, for a long time have relied on other professions for a determination of value either for an asset or liability. The engineer is consulted on the physical value of a property, the lawyer on the legality of a bond issue, and certainly the actuary would be consulted on the insurance reserves required to be set up as a liability. As a matter of fact that is exactly what happens when the insurance examiners comment on the reserves or the asset value of a piece of real estate. They state that the reserves are adequate according to the Actuarial Bureau of the Insurance Department, or the valuation of real estate is correctly stated according to the Real Estate Bureau of the Insurance Department.

This section on accounting personnel has been included as a possible explanation of the peculiarities of some principles governing life insurance accounting. Those of you who are all ready to form a committee on cooperation of

² Hearings Before The Temporary National Economic Committee March 1, 1940, part 28, pages 15433-4 of the report.

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CPA's with actuaries may relax. As far as internal accounting is concerned, the complexities of the many problems are developing accountants whether they are called by that name or are called actuaries. More and more of them are subscribers to accounting publications and in many cases members of accounting societies. As far as public accountants are concerned, the services which the CPA's can contribute are slowly being appreciated. I believe that soon it will be an unusual situation for a life insurance company not to have its operations and its condition examined by certified public accountants.

Comparison of Life Insurance Accounting with Conventional Accounting

Life insurance accounting is a special division of accounting. It has its own terminology; for example, a reserve and dividend in insurance accounting have different meanings than those we understand in commercial accounting. In a paper like this, it is possible only to give some of the major differences without inquiring too deeply into the reasons for the differences which were, however, indicated in the previous section. The term "conventional accounting" is used as a basis for comparison. It is appreciated that there are great variations in accounting between industries which can be covered by that term. Furthermore, even within an industry there are considerable differences in accounting. Nevertheless, most of the terminology used in conventional accounting is based upon the Accounting Research Bulletins published by the American Institute of Accountants.

Assets. This word appears in both insurance and conventional accounting and fundamentally means the same, i.e., resources such as cash, investments, etc.³

Ledger Assets. This term is used in insurance accounting and means assets,

a record of which is kept in an account in the ledger or is controlled by an account in the ledger. In conventional accounting all assets usually are kept in that manner. As we shall see, only some of the assets of a life insurance company are so kept.

Non-Ledger Assets. In insurance accounting, this term means assets which are not recorded in a ledger or a subsidiary ledger controlled by an account in the ledger. These assets are no less valuable than ledger assets. They are non-ledger because usually there is no formal entry in an account. Periodically, when required, the value of these assets is determined by inventory. The basis for the inventory may be a memorandum record or a calculation. An example of the type of asset which would appear as "non-ledger" is "Interest Due on Bonds." Some life insurance companies do make formal entries but the nomenclature of non-ledger assets still is observed to indicate this class of asset. This term does not appear in conventional accounting.

Non-Admitted Assets. In insurance accounting, this term means assets which are included in the ledger and non-ledger assets but which are not acceptable as being admitted or valid. The reason for so classifying an asset may be a regulation of the Insurance Department or a decision of the life insurance company. The deduction of non-admitted assets gives approximately the same effect as when a valuation account is used in conventional accounting.

Admitted Assets. They are the total of all ledger and non-ledger assets less the total of non-admitted assets.

Liabilities. This word appears in both insurance and conventional accounting and fundamentally means the same, i.e., an obligation or debt such as salaries due or accrued.⁴ Relatively few life insurance companies keep liability accounts on the books of the com-

³ See Research Bulletin #9 for a technical definition.

⁴ See Research Bulletin #9 for a technical definition.

pany. When required they are derived in the same way as non-ledger assets, by inventory.

Policy Reserves. The greatest amount of the liabilities consists of these reserves. They are determined by the actuaries based upon the types of policies issued. They are "the funds earmarked by the life insurance companies for the fulfillment of their obligations to policyholders. At any given time the amount set aside in these reserves is sufficient, with future premiums and interest, to take care of these obligations as they come due. The maintenance of these reserves is necessary for actuarial soundness, and is required by law. This is why policy reserves are frequently known as 'legal reserves'".⁵ Despite the valiant attempt of the Committee on Terminology, in conventional accounting the term reserve still is used in a variety of different senses.⁶ In banks, the term may be an asset as a deposit kept in a reserve bank. The same word also is used to indicate a deduction from an asset, e.g., reserve for bad debts. Finally reserve also is used in conventional accounting to mean a liability or part of the surplus.

Other Liabilities. Without going into a detailed description of each of the other liabilities of a life insurance company, it may be stated that they are approximately the same as in conventional accounting. Unlike assets, the words *ledger*, *non-ledger* and *admitted* do not modify liabilities in insurance accounting. As stated liabilities usually are not entered in the books at all.

Surplus. This word appears in both insurance and conventional accounting. Essentially it is the balance of the net profits, income and gains of a company from the date of its existence.⁷ In a mutual life insurance the surplus is entirely for the protection of the policyholders.

⁵ Life Insurance Fact Book, 1952.

⁶ See Research Bulletin #34 for a technical definition.

⁷ See Research Bulletin #9 for a technical definition.

Form of Presentation. There is a wide difference in form between insurance and conventional accounting. In insurance accounting there is no distinction between current and fixed assets. The reasons are the requirements of the state insurance departments and also the very nature of the business where such a distinction would have little meaning.

Miscellaneous. Other words have a particular meaning in life insurance accounting. *Premiums* are the cost to the policyholder for his insurance protection. *Dividends* are a return of part of the premiums received by the life insurance company and not a distribution of profits as in conventional accounting.

Regulatory Body

As previously explained, part of the reason for some of the forms and accounts used by life insurance companies is their desire to comply with the laws which govern them. Each state has its own insurance laws. Considering that many companies operate in all the states, chaos would seem to be the result of trying to comply with all the laws. Strangely enough such is not the case. All states have a Commissioner of Insurance or his equivalent. Representatives of these officials meet during the year and strive for uniformity of administration. Although the laws of the various states vary slightly, they are uniform enough so that an examination of a company by one or more states is accepted by all. Like the National Conference of Commissioners on Uniform States Laws which came into existence in 1894, and which is responsible for the Uniform Negotiable Instrument and other acts, the National Association of Insurance Commissioners have been meeting since 1871 on a voluntary basis and its achievements also have been tremendous.

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The examinations of the insurance companies usually are done by members of the staff of the insurance department or by public accountants or consulting actuaries retained by the state for that purpose. These examinations are performed periodically, at least once every three years, which is the rule in New York State. The fees for the examination, which are quite reasonable for the scope of work performed, are paid directly by the company examined. In addition to the triennial examination, the regulatory bodies receive from the life insurance companies quarterly and annual reports which serve as a basis for an office review. The annual report is in the form of the annual statement which is discussed in some detail later.

So far there is not a uniform method of accounting prescribed for life insurance companies. One section of the accounting, however, is covered by regulations. That section has to do with real estate purchased for investments which includes the recently popular type of "buy-lease" arrangement. For this asset the insurance law in New York State specifies that the Superintendent may prescribe a uniform classification of all items of investment, income and expense, and a uniform method of reporting such operations.⁸ This has been done by Regulation 28 of the Insurance Department. The regulation gives a fairly detailed description of the type of accounting which is required. It is believed that such uniformity will be extended in the future to cover all accounting activities of life insurance companies. Indeed, a bill was introduced in the last session of the New York State Legislature to give the Superintendent that power. Whether such regulations are required is beyond the limits of this paper. It may be mentioned, however, that unlike public utilities there is strong competition between all companies which tend

to keep the expenses down. The present insurance law in New York State (Para. 70) already states which assets may be admitted and gives the Superintendent of Insurance broad powers in such determination. The same law (Para. 207) also states what the maximum amount of the surplus may be.⁹ Finally, the insurance law (Para. 217) states that "every life insurance company doing business in this state shall conform substantially to the form of statement adopted for such purpose by, or by the authority of, the National Association of Insurance Commissioners . . .".

The Statement and Instructions

The blanks which are used by the life insurance companies for their annual statements, are furnished by each of the states in which the companies do business. In size the blank is rather formidable looking as it measures a little over a foot and a half by a foot. The main part of the statement consists of seventeen pages. The second part contains the number of pages which are required to list all the schedules and which is dependent on the size of the company. Permission is granted to the companies to use their own blanks provided they conform to the official blanks. Most of the companies take advantage of this privilege.

The instructions on the use of the blanks are on sheets measuring about the same size as the blank and consist of eight pages. The instructions go into considerable detail—so much so that it would appear that if all the companies filled out the blanks properly, all would be on the same basis for comparison. It will be seen that this is not so because the instructions still are subject to different interpretations. In fairness to the authors of the instructions it should be mentioned that there is a foreword which states

⁸ New York State Insurance Law, Section 81-7(h).

⁹ The limitations on surplus is \$750,000, or 10% of the policy reserves and liabilities, whichever is greater.

"It is expected that they (instructions) will be modified as experience with the revised blank is evolved." After the statements have been reviewed and the companies have been examined, it is supposed that there will be more uniformity of interpretation.

Page one of the annual statement contains the date of the statement, the name and address of the company, the names of the principal officers and the names of the directors or trustees. Pages two and three are very similar to the balance sheet used in conventional accounting. Page four gives a good approximation of the income statement and a surplus statement which are familiar to all. Pages five and six give an analysis of operation by lines of business and an analysis of policy reserve increases during the period covered. Pages seven through fourteen consist of exhibits supporting the balance sheet, income statement or other exhibits. Pages fifteen and sixteen show some statistics regarding the business. Page seventeen contains a list of questions such as whether the company is a mutual company. In explaining the statement and the accompanying instructions, the order of the instructions will be followed.

General.

As the name implies, these instructions are of a general nature such as the date of filing, the requirement that the name of the company must appear at the top of all pages, exhibits and schedules.

Assets—Page 2.

This part with the "Liabilities, Surplus, And Other Funds" comprise the balance sheet of the statement. It is a strange type of balance sheet for those of us who are accustomed to the conventional type. There is no separation of current and fixed assets. There is, however, a division between cash and invested assets and all other assets. The first group includes bonds, stocks, mortgages, real estate, policy loans, premium notes, collateral loans, cash

and bank deposits. The second group includes amounts recoverable from re-insurers (another company which assumed part of the risk), life insurance premiums and annuity considerations deferred and uncollected, accident and health premiums due and unpaid, interest and other investment income due and accrued. There are a number of blank lines for the use of the reporting company to include any other asset which is not printed.

The instructions are very brief. The reason for this is that most of the accounts are brought over from schedule or are self-explanatory. Before leaving this section, it should be mentioned that the type of investment is closely regulated and that the value allowed to be shown on the statement is closely checked by the personnel of the various state insurance departments.

Liabilities, Surplus, and Other Funds—Page 3.

Similar to the assets, there is no division between current and fixed. There are separate lines to show liabilities or reserves for the policies and contracts and to show liabilities for commissions and other expenses. Many of the liabilities are supported by exhibits. The surplus section is divided into special surplus funds and unassigned surplus, both of which are added to give a grand total for surplus. If the company is a stock company, the amount of paid up capital also is shown in this section. Again there are a number of blank lines provided so that the company can show items which are not printed on the form.

The instructions consist mostly of telling the insurance company to include as a liability any item for which there is a possibility that it may be an expense or payment. The instructions tend to make the statement very conservative. For example, amounts owed to agents must be shown as a liability but amounts owed to the company by agents cannot be shown as an asset. There is also a special instruction that these two items cannot be shown as

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net. The instructions also state that the special surplus funds are voluntary and general contingency reserves and not liabilities.

Summary of Operations—Page 4.

This is on an accrual basis and is a type of income statement. As stated earlier, most of the companies keep their books on a cash basis. When an accrual statement is required, an inventory of many items must be taken. Many of the accounts shown on this summary refer to exhibits. As we shall see, these exhibits in turn refer to the books of the company for the cash items and to the inventories for the accruals. The first part of the summary, lines 1-7, gives a total of all income from premiums, investment income, capital gains and other classes of income. The second part, lines 8-20, lists all payments on the policies or contracts such as for death benefits, matured endowments, surrender benefits and increases in policy reserves. The third part of the summary, lines 21-26, lists the general expenses such as for commissions, taxes, net capital losses, etc. Line 27 shows the total of all payments of the amounts shown in parts 2 and 3; line 28 shows the net gain from operations before dividends to policyholders and is the difference between the total income as shown in part 1 and the total disbursement as shown on line 27. The fourth part of the summary gives the disposition of the net gain as a dividend to the policyholders or a transfer to surplus.

The instructions are brief as the items which might be questionable are brought forward from exhibits and are covered there. One notation might be of interest and that is that some of the items may be either positive or negative on the summary.

Surplus Statement—Page 4, bottom.

The surplus as at the end of the prior year is shown. To this is added the net gains from operations after dividends to policyholders, capital gains

affecting surplus, paid in surplus and any other items which increase surplus. From this is subtracted any dividends to stockholders, if a stock company, capital losses affecting surplus, and any other items which would decrease surplus. The final amount is the surplus as at the end of the current year.

Analysis of Operations by Lines of Business—Page 5.

This is similar to the Summary of Operations. The purpose of this analysis is to allocate income and expenses to the various lines of business which are carried by the company, such as life, annuities, accident and health.

Analysis of Increase in Reserves During the Year—Page 6.

Columns are provided for the various risks such as for life insurance, disability, annuities, etc. The first amounts are the reserves as of the end of the previous year. To these are added or subtracted certain amounts which are supposed to reflect certain changes on the reserves. This analysis is prepared by the actuaries and is somewhat theoretical.

Exhibits.

The addition of a number of exhibits in the new statement form is the reason that it appears to conform so closely to the statement used in conventional accounting. Various terms which were discussed, such as ledger, non-ledger, and not admitted assets, now appear only in the exhibits.

Exhibit 1.

This exhibit is divided into two parts. Part 1 contains the premium income. This income is derived from the books of the company (collected during year) and usually from an inventory of the individual policy record cards for deferred and uncollected items. There are columns provided so that the income can be distributed by lines of business carried by the company. The totals are brought forward to the Summary of Operations.

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Part 2 of the exhibit contains an unrelated mixture of dividends applied, reinsurance ceded and commissions incurred. The dividends applied section refers to another exhibit (#7) and seems redundant. Its purpose here, however, is to show a distribution of the dividends by lines of business. The section containing the reinsurance ceded shows the premiums paid to other insurance companies to share in certain risks. The section containing information on commissions is a breakdown of the commissions paid for various lines of business and is further divided into first year, single and renewals.

Exhibit 2.

In addition to receiving premiums as income, there is considerable income from the money invested by the life insurance company. This exhibit is a summary of the net investment income on an accrual basis. The first line shows the total of interest, dividend and real estate income with a reference to Exhibit 3 for details. The amounts shown on lines 2, 3 and 4 are deductions for investment expenses, taxes, licenses, fees and depreciation. Again reference is made to other exhibits for details. The net investment income is carried forward to the Summary of Operations. Exhibit 2 also contains the ratio of net investment income to mean assets in accordance with the directions given in the instructions.

Exhibit 3.

This exhibit gives the details for the investment income on line 1 of Exhibit 2. Itemized are amounts to show interest on bonds, dividends on stocks, interest on collateral loans, mortgage interest, real estate income, interest on premium notes, interest on policy loans and liens, and interest on bank deposits. In most companies only part of this information (amounts collected during the year) is taken from the books of the company. The unearned, due and accrued items usually are

memorandum entries for the annual statement only. In this exhibit the term non-admitted is used. As previously explained, non-admitted or not admitted is essentially a valuation amount. As the instructions point out, this amount should include "any deductions or exclusions such as investment income overdue more than a certain period".

Exhibit 4.

This exhibit provides for an analysis for the capital gains and losses on investments. Columns are provided to show the increase or decrease in the book value of the assets, to show the profit or loss on sales, to show the net gain or loss from changes in difference between book and admitted values and, finally, to show the final gain or loss for each asset.

Exhibit 5.

Although many attempts have been made, and for some companies with a fair degree of success, the industry of life insurance is far short of a good cost system. To remedy this situation somewhat, the instructions are quite detailed for this exhibit of general expenses. Besides the item column, four columns are provided. The item column lists all the types of expenses such as rent, salaries, wages, etc. Columns 1, 2, 3, and 4 are used, respectively, to provide for an allocation of expenses to life, accident and health, investments, and finally to provide a total for each item. No one method is required to be used for the allocation but the department is trying to determine such a method.

It may be of interest to note that one of items of expenses which is listed, is "Auditor's Fee." This is the first time such a line appeared on the official statement and its use is still optional.

Exhibit 6.

This exhibit is similar to Exhibit 5 except that it lists taxes, licenses and

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fees. Both of these exhibits contain lines to show unpaid items as at the end of the current and previous years, so as to place the exhibits on an accrual basis. As discussed, most companies make an inventory of these unpaid items as they do not appear on the books.

Exhibit 7.

This exhibit gives a breakdown as to how the dividends were paid. These are dividends to policyholders who may take them in cash, leave them to accumulate at interest, apply them to pay the premium, or use them in a number of other ways.

Exhibits 8, 9 and 10.

These exhibits contain a detailed classification of the reserves. The total of these reserves comprises the largest class of liabilities. The determination of the amounts is done by actuaries.

Exhibit 11.

Here are listed by class of business the claim liabilities as at the end of the current year and the amounts incurred during the year. Claims for accident and health policies are not included.

Exhibit 12.

This exhibit is called "Reconciliation of Ledger Assets." Essentially it is a trial balance of the ledger. All items increasing or decreasing the ledger assets are shown.

Exhibit 13.

All the assets of the company are listed in this exhibit. Columns are provided for ledger assets, non-ledger assets, not admitted assets, and net admitted assets.

Exhibit 14.

This is an analysis of non-admitted

assets and related items. It lists these items as at the end of the previous and current years. A column also shows the net changes between the years.

Statistics.

Pages 15 and 16 of the statement show the amounts and numbers of policies and annuities. Columns are provided for classification by whole life, term, etc. An analysis shows the numbers as at the beginning of the year, the activity during the year and the number at the end of the year.

General Interrogatories.

Page 17 lists questions which the company must answer. Included are such questions as to whether the company has shown all transactions, liabilities, etc.

Schedules.

The life insurance companies must list in considerable detail all their assets in schedules provided by the insurance departments. In addition other schedules are required. These include schedules listing payments made to certain individuals, vendors and for legal fees. For companies doing business in New York State, a schedule also is required to show that they have complied with the legal limitations on expenses.

Conclusion

The only purpose of this paper is to indicate certain peculiarities in life insurance accounting. Also presented was a summary of the recent changes in the annual statement which must be prepared by life insurance companies. The insurance commissioners of the various states are charged with grave responsibilities to protect the policyholders. They cooperate very closely with committees formed by life in-

surance companies so that the affairs of the companies can be reviewed intelligently. It is believed that the recent statement is a good step in that direction.

For a scholarly presentation of the history and background of certain re-

quirements and for a thorough review of life insurance accounting, reference should be made to "Life Insurance Statements And Accounts" by E. C. Wightman (Published by Life Office Management Association, N. Y. C., 1952).



AN ADIRONDACK VIEW

Economics. Not a very large word is it? But it covers quite a large field. It seems to get into all human activities the same as air gets into every possible space. Can you name any undertaking that doesn't get mixed up with economics? We are not saying you can't, we are just asking—you know, just wondering.

The dictionary says it's a science—we wonder about that, too—what are the scientific facts of economics that you know? Can you get beyond the law of supply and demand? Do you have in your office library a book on economics? (Do I have one? Yes, sir; Seagers, published in 1913; the last time I blew the dust off of it must have been at least 10 years ago. Page 1, "Economics is the social science of business.")

Now, can you figure this one out in your head, or find the answer somewhere in a book? A man builds a nice house and it costs him \$35,000; after he has it completely built he can sell it for only \$15,000; has he lost \$20,000? Has anybody lost \$20,000? If so, who? Has the national wealth then decreased \$20,000?

I'm just asking; you ask some of your friends and, dollars to doughnuts, you'll start more arguments than you'll get acceptable answers.

LEONARD HOUGHTON, CPA
"Adirondack Chapter."

Problems in Realizing Income as Long-Term Capital Gain

By MARTIN WOLMAN, C.P.A.

WITH ordinary income taxed at a maximum of 92% and long-term capital gain taxed at a maximum of 26%, the pressure on the professional accountant and tax man to work the miracle of conversion—from ordinary income to capital gain—has become very great. As a matter of fact, it is probably safe to say that one of the leading "industries" in the United States today is the one devoted to the task of manufacturing capital gains. A capsule review of a number of the classical attempts at conversion and the varying degrees of success encountered may therefore prove interesting and, at least psychologically, perhaps profitable. In this connection, note that there is nothing inherently wrong in so arranging a transaction as to create long-term capital gain rather than ordinary income, provided that the steps taken are real and not fictitious or ephemeral.

In principle, the problem of capital gains and losses is no different from any other tax problem of income or deduction. Given the definition of "income" under the 16th amendment, it soon became clear that it was entirely a matter of Congressional policy to

determine what kind of income (within that definition) should be included or excluded—and to what extent, and what kinds of expenses or losses should be deductible from income—and to what extent, in arriving at the tax base. The obvious implication of this background is that we must have a perennial tug-of-war concerning the items of income and deduction to be afforded special tax treatment. The problem then becomes one of setting the standards for special tax treatment.

Policy

Beginning as far back as 1921, a pet item has been the special treatment of capital gains and losses. This special treatment is based upon the following policy considerations:

- (1) It is unfair to recognize, as income in *one year*, increment which has accumulated over a *number of years*; and it is administratively inexpedient to spread and recognize (tax) the increment *over the years, as accumulated.*
- (2) Income from speculation must be distinguished from income from investment because (a) the former is in the nature of ordinary (earned) income whereas the latter is not, and (b) in fact may not be income at all.
- (3) Giving favorable tax treatment to capital gains justifies converse tax restrictions on capital losses, particularly when the taking of gains or losses is completely within the control of taxpayer.

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This paper was presented by him at the Society's Federal Tax Conference, held on November 17-18, 1952, at the Manhattan Center, New York, N. Y.

(4) Retarded sales of property harms the economy, by preventing the "free flow of capital into productive enterprises", and harms the revenues, by decrease or instability.

These policy considerations should be kept well in mind in connection with the problems we shall now discuss, if for no other reason than to observe how far afield the courts and legislators may go.

You are all familiar, of course, with the capital gain and loss section of the Code, Section 117. The problems discussed herein and the related court cases primarily revolve around literal or quasi-legislative interpretations of the basic statutory factors: definition of "capital asset", of "property" within "capital asset", of "sale or exchange" and of "trade or business."

The typical problem is the conversion of compensation for personal services rendered. Such compensation of course is ordinary income. But if one can transform the income into a "thing"—into "property", within the definition of capital asset, then conversion becomes that much easier. Consider, for example, a book, a painting, a musical composition, a radio or television "package", a patent, a contract, a theatrical production, a cartoon strip, or even corporate stock.

Let us first discuss four such situations where services are transformed into property: copyrights, patents, contracts and corporate stock.

Copyrights

The property which the amateur author, playwright or composer creates by his personal effort is the bundle of rights known as the copyright. Sale of only a portion of this bundle of rights, as in the *Irving Berlin*¹ and *P. G. Wodehouse*² cases, is not considered a sale for purposes of Sec-

tion 117 benefits. For example, sale of motion picture rights, only. The courts talk somewhat ambiguously of the contract being a "license" or "in the nature of personal services", but are apparently thinking in terms of the legislative policy considerations outlined above.

Sale of the entire bundle of rights, however, is considered a Section 117 sale. Thus, by taking a position literally outside the technical wording of the exceptions in Section 117, it was previously possible for an amateur writer or other artist to create a long-term capital gain by holding the book or other artistic work for over six months and then selling it outright. Since the asset was not held "in the ordinary course of taxpayers trade or business", it was a capital asset, despite the fact that it was the product of his personal effort. Probably the two best known and quite successful beneficiaries of this device were General Eisenhower ("Crusade in Europe") and Kathleen Winsor ("Forever Amber").

Similar problems, in a slightly different field of endeavor, are illustrated by the sale several years ago of the *Amos 'n Andy* (Correll & Gosden) show and the *Jack Benny* show, the former presumably successful in obtaining capital gain treatment, the latter not. The reasons for the apparent success of the former were three-fold: they were able to prove (1) the show (the package) was not held primarily for sale (but for performance), (2) the show package was "property"—distinct and separable from the owners, (3) the consideration was attributable to the property—no part was attributable to the personal services of the owners.^{2a}

The singer or musician is in a particularly difficult position. Since the essence of his product is personal performance, his earnings are inevitably ordinary income. The recording artist is in a somewhat better position—since he transforms his personal services into

¹ *Irving Berlin*, 42 BTA 668 (1940).

² *Wodehouse v. Comm.*, 337 U. S. 369; rehearing denied, 338 U. S. 840.

^{2a} The latter show appears to have come within the scope of an adverse ruling referred to later herein under the heading, "Corporate Stock."

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property—the record. But normally he has no proprietary interest in the record and, in any event, how could he disassociate himself from the property? Further, if he made his own records, they would probably be deemed to have been made "primarily for sale to customers."

Section 117(a)(1)(c) and the concomitant section 117(j)(1), enacted in 1950, now specifically except from capital gain treatment copyright, literary, musical or artistic compositions and similar property (radio programs, etc.) for a taxpayer (or a substitute, e.g., donee) whose personal efforts created such property.

The exception to the effect of this section mentioned in the committee report should create some fascinating distinctions. The report states "the interest of a sole proprietor in such a business enterprise as a photographic studio is not 'similar property' even though the value of the business may be largely attributable to the personal efforts of the sole proprietor." How does one distinguish between the professional photographer and the professional, let us say, recording artist or painter. All need a certain amount of equipment. Is there a significant difference between the painting and the photograph?

Patents

The inventor of course, translates his personal services into property in the form of a patent and the problems are similar to but not the same, as for the copyright. Again, a taxpayer must sell the entire bundle of rights to qualify, but a sale of the entire rights in a part interest is acceptable, as is the computation of price according to units or royalties. The patent is not however included in Section 117(a)(1)C, above noted, outlawing the copyright for this purpose.

The Senate Committee report notes "the desirability of fostering the work

of such inventions", apparently in contrast to the desirability of encouraging the more artistic endeavors—a rather interesting revelation in the light of current debate on materialistic philosophy. Philosophy notwithstanding, the truly amateur inventor should not find too much difficulty in obtaining capital gain treatment on a sale of his patent and, indeed, the courts have generally strained to maintain the "amateur" status of the inventor despite facts which would appear to offer a contrary opportunity. In any event, if the taxpayer is deemed to be in the business of selling inventions, he still may be afforded the capital gain treatment under Section 117(j) for "depreciable property used in trade or business", provided he avoids running afoul of "sale to customers in the ordinary course of business."

Contracts

Contracts for the performance or non-performance of personal services are not considered capital assets; in fact, they are not considered "property."

On the other hand, the sale of an exclusive agency for leasing machines was held to be the sale of a capital asset, as was the surrender of an insurance agency contract. A very current case³ involved the sale of Frank Sinatra's contract with his booking agency, General Artists Corporation, to another agency, Music Corporation of America. It was held that this was not a sale of a capital asset, although the fatal defect (sale or capital asset?) was not made very clear.

It is interesting to note in passing that, where a covenant not to compete is not involved (payment for which is ordinary income), the sale of an accounting practice is considered to be the sale of goodwill and is taxable as capital gain.

Assume a corporation is engaged as licensing agent for motion picture producers, and is entitled to a 20% commission on all licensing contracts. It

³ *General Artists Corp.*, 17 TC 1517.

licenses a group of pictures to a television network for five years for a total sum of \$1,000,000, payable over a two-year period. It thus becomes entitled to an eventual \$200,000 commission. Is the \$200,000 accrueable (realized) immediately upon the signing of the contract? Is it deferrable over two, or five, years? Suppose the commission contract is sold to an outside party. Does this result in capital gain? Suppose it is distributed to stockholders in liquidation. Is this a capital gain? Double taxation—to corporation, then to stockholder? Suppose the value of contract is unascertainable—based upon future profits, etc.? Suppose further agency services are necessary?

This type of problem, whose solution is related to the result in the *Eubank*⁴ and *Horst*⁵ cases involving questions of assignment of future income, should also be carefully considered, as should *Susan Carter*⁶ type cases, involving transfer of intangible assets (contracts) to stockholders upon corporate liquidation, questions of taxability to corporation or stockholder, and treatment as ordinary income or capital gain.

For those who are not familiar with the cases just mentioned, the *Eubank* case concerned an assignment by husband to wife of income the husband had already earned but had not yet received. The Supreme Court held the income taxable to the husband. In the *Horst* case, a taxpayer detached interest coupons from bonds he owned and transferred them to his son just prior to their maturity. The Supreme Court again held the interest taxable to the father, although received by the son. In the *Carter* case, a cash-basis corporation was liquidated and accounts receivable (for merchandise shipped and billed) were transferred to stockholders. The corporation was held taxable, although the income was actually collected by the stockholders.

Corporate Stock

Suppose the artist transfers his property to a corporation for its capital stock. Will that be helpful? Probably not, as the identical problems discussed above would be involved and the corporate veils quite easily pierced. In the situation discussed above, Jack Benny had transferred his radio show to a corporation, Amusement Enterprises, Inc., in return for 60% of the capital stock and the sale in question was a sale of this stock not of the radio show itself. The Bureau's ruling did not refer specifically to Benny but was a general rule intended to scotch reports that entertainers were rushing to set up corporations to sell their services as property. The ruling stated that "the tax effect of any business transaction is determined by its realities. Accordingly, proposals of radio artists and others to obtain compensation for personal services under the guise of sales of property cannot be regarded as coming within the capital gains provision of the Code." This would be too obvious a loophole to Subchapter A, relating to Personal Holding Companies.

This brings us to another phase of the same problem. Unless the taxpayer artist is one of the rarities who is not only in a very high income tax bracket but who, also, has substantial capital, he will find the classification of "Personal Holding Company" too onerous to be of substantial practical value, and if that classification is not fatal, then the impact of Section 102 probably will be.

If the "property" he transfers to the corporation is tangible, rather than a personal service contract, he will then face the spectre of the new collapsible-corporation Section 117(m) (which is discussed in detail in another paper to be presented in this forum group). It is noteworthy that Section 117(a)(1)C,

⁴ *Helvering v. Eubank*, 311 U. S. 122 (1940).

⁵ *Helvering v. Horst*, 311 U. S. 112 (1940).

⁶ *Comm. v. Susan J. Carter*, 9 TC 364; affd., 170 F 2d 911 (1948).

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adding the new exception to the definition of capital asset discussed above, does not apply to this situation, where property, tangible or intangible, is transferred to a corporation for its stock. Instead, the controlling section is 117(m). While the leeway in Section 117(m) is also extremely limited, it may be worthy of study in this connection.

Of passing interest in this category, what of the lawyer or accountant who accepts stock in a newly formed corporation, in lieu of services. Assuming that he earns ordinary income to the extent of the fair market value of the stock, which then becomes his basis for future disposition, any gain on a future sale will undoubtedly be a capital gain.

This concludes our discussion of the transformation of personal services into property and the effects thereof. We now turn to four situations where other forms of property, unrelated to personal services, are involved.

Short Sales

It is one thing to obtain the benefit of long-term capital gain treatment. It is an entirely different matter to guarantee your gain in a market during the six months waiting period. An ingenious device to accomplish both objectives flourished prior to the 1950 amendment, in the form of a short sale assuring gain and a deferred closing of the short sale until an original investment in the same securities could be held for over six months. This too is no longer possible, under Section 117(1).

Inventory

Suppose an individual owns inventories which have substantially appreciated in value. Sale in ordinary course will, of course, result in ordinary income. Instead, he transfers the inventory to a corporation for its stock (a non-taxable exchange) and then sells the stock. Under previous law, this produced a capital gain. Under the 1951 amendment to Section 117(m)

(collapsible corporation), this is no longer possible.

Life Estates

The cases uniformly hold that a life estate is a capital asset and that a sale of a life estate, for example, by life beneficiaries of a trust to the remainderman, results in capital gain, not ordinary income, even where, as would ordinarily be the case, the life estate has no cost basis. The courts speak of the assignment as a transfer of an interest in the trust assets, rather than "a mere assignment of the naked right to income." The "property", in other words, is the carved out portion of the total transfer, and the definiteness of the actuarial calculation of value is probably an important factor.

Oil Wells

The Regulations (29.23 (m)—16 (b) (1)) grant an oil well "operator" the option to charge to expense or capitalize "intangible drilling and development expenditures" (wages, fuel, repairs, hauling, supplies) incurred by the operator himself or through a contractor, after 1942. An operator is defined as "one who holds a working interest or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights."

For the taxpayer in exceedingly high tax brackets, this regulation creates a fair gamble for ultimate capital gain. For example, if taxpayer is in the 88% bracket, a \$500,000 expenditure in drilling one development, if unsuccessful, will cost \$60,000, as against the probability of striking a successful oil well, in the \$500,000 drilling expense class, which can be retained for profitable production subject to the very attractive depletion allowances or sold as a capital asset.

Capital Losses

A word about capital losses may not be amiss, with the similar problem in mind of converting the limited capital

loss to the fully deductible ordinary loss.

The same general policy considerations outlined above motivated Congress in providing for losses as for gains. The legislative history is interesting. The 1921 Act permitted a net capital loss deduction in full. The 1924 Act limited the deduction to 12½% maximum, as for gains. During the depression years of the early Thirties, this deduction was widely used to offset ordinary income, since, although limited to 12½%, losses were so extensive as frequently to wipe out ordinary income in the highest brackets. The 1932 Act only partially corrected this by allowing short-term losses only to the extent of short-term gains, but continued the limited (12½%) long-term deduction. The 1934 Act further limited the deduction to a maximum of \$2,000. The 1938 Act segregated short-term and long-term transactions and maintained that segregation. The 1942 Act segregated by holding period for maximum rate only, provided for a five-year carryover, but for all other purposes abandoned the distinction. The 1951 Act removed the 50% recognition feature.

Under the loss category, let us finally discuss two situations: personal residences and stock options.

Personal Residence

The classical illustration of the problem of loss deduction concerns the sale of a personal residence (where a new residence is not purchased). The rules make a clean-cut distinction between the sale of a residence *used as a residence* to the time of sale and the sale of a residence previously converted to rental or to other income-producing purpose. Since the former transaction was not "entered into for profit", under Section 23 (e) a loss is not deductible at all, although gain is still taxable, as

capital gain. Where the residence is converted to income-producing purpose, however, the loss is deductible and in full.

There still appears to be doubt in the cases where taxpayer abandons the residence and makes every effort to rent but is unsuccessful. If the reason for disallowance of a loss under such circumstances is evidentiary, that is understandable; taxpayer hasn't *proved* his transaction has been converted to an income-producing purpose. Otherwise, it would appear that taxpayer should at least have the benefit of an intermediate deduction, the capital loss deduction, since the property became investment property, no different from any non-productive property held for sale or rental at a profit.

Stock Options

Another illustration of the loss phase of the problem occurs under Section 117 (g), wherein a loss attributable to the failure to exercise an option is considered a short-term capital loss, regardless of the holding period. On the other hand payment in the form of "liquidated damages" for failure to exercise an option has been held to be an ordinary loss. Perhaps the hurdle can be jumped.

Conclusion

Under the tremendous impact of the highest tax rates in our history, ordinary income dwindles to what must seem like nothing, particularly to the taxpayer whose income "bunches" unduly in one year. The alleviation of tax afforded by Section 107 is so limited that efforts to reduce the impact by other means, within the sphere of "tax avoidance", are inevitable. This discussion has been an attempt to review, in brief, some of the history of such efforts made in the past, as a lead to the inevitable efforts of the future.

More Problems in Realization of Income as Long-Term Capital Gain

By AUGUSTUS MORRIS, C.P.A.

Interest

There is an often overlooked method of converting interest into capital gain. That is through the use of a discount bond. The ordinary interest-bearing obligation gives the creditor fully taxable ordinary income in the form of regular interest payments. But the use of a discount bond—by which is meant a bond issued at less than par—can have a two-fold advantage to a cash basis creditor:

1. *Deferred income.* The bondholder realizes no gain or loss until the bonds are redeemed or sold. There is no need to report the discount ratably over the period of the loan. Thus, while he is getting the equivalent of income each year, no tax is due till some future date.

2. *Capital gain.* When the bond is redeemed, the bondholder doesn't have fully taxable income. Instead, the income is treated as long-term capital gain.

The corporation is no worse off than if it had issued a regular interest-bearing obligation. Since the discount can be amortized over the period to maturity, the corporation gets the same deductions as if it had paid interest regularly.

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Discount Can Cover All Interest

In the common situation, there is a substantial interest payment and a moderate discount—a 4% bond may be issued at 90. To the extent of the discount there is a deferred income and conversion into capital gain. But the saving can be substantially increased if the bond is issued with *no interest payments*. The entire interest is then reflected in the discount which becomes a capital gain on maturity. If the bond provides for interest figured on a cumulative basis, the taxpayer not only defers the payment of any tax until maturity, but in addition has a higher amount of income than otherwise. He has interest compounded on the full amount of interest, not on interest less tax.

If a person in the 40% bracket invests \$10,000 in a 5% interest bearing bond and the yearly interest received is invested at 5%, he will (after taxes) have accumulated \$1,590 of interest at the end of five years, \$3,440 at the end of ten years. On the other hand if he invested in a cumulative 5% discount bond he would be entitled to \$2,760 of "interest" at the end of five years, \$6,290 at the end of ten years. The amount due on the discount bond would still have to go through the wringer of a capital gains tax. However, the levy could be small if the payments are received when the bondholder's income is at a low level because of retirement, illness, etc.

Staggered Maturity Dates

The capital gains tax is a maximum ceiling not a minimum tax. It can be less than the present maximum of 26% (or 25% in future years) if the taxpayer's top bracket is less than 52%

(or 50% in future years). If the bond maturities are "staggered" over a number of years, spreading the realization of the gain over a number of years can further cut the tax burden. Take the extreme case of a married couple who are retired and over 65, and have no other income. They can realize a *yearly gain* of over \$5,300 from redeeming discount bonds without being taxed on any income. Only half of the long-term capital gain would be taxable and they would have \$2,400 of personal exemption to offset it, as well as their deductions.

Closely Held Corporations Can Also Get "Break"

If the bondholder is also a stockholder who owns directly or indirectly more than 50% in value of the outstanding stock, the corporation may lose the deduction for amortizing the discount under the 2½-month rule (accrued expenses to cash basis taxpayers must be paid by 2½ months after the end of the year).

But the danger of being hit by the 2½-month rule doesn't necessarily bar the use of these bonds for all small corporations. Many of them are owned by two or more persons so that no one stockholder has more than 50% of the corporate stock.

Form of Bond Important

In order to have any gain on redemption of bonds treated as a capital gain, the obligation must be that of a corporation (or government or political subdivision) and be evidenced by a bond, debenture, note, certificate or other evidence of indebtedness *with interest coupons or in registered form*. It shouldn't be a problem to make sure that the obligation meets this test. In one case, creditor's notes which were numbered serially, and for which a record of noteholders was maintained by the debtor corporation, were held to be in registered form.

Treasury Attitude on Changing Interest to Capital Gain

The Tax Court and the Sixth Circuit have allowed this method of converting interest into capital gain in the case of a non-interest bearing investor type of certificate with an increasing redemption value. Although the Treasury acquiesced, it has informally indicated that it will limit its acquiescence to the specific type of investor certificate involved in that case. However, as a matter of law, there appears to be no justification for this limitation.

The Treasury's attitude on discount bonds or notes is that on either a sale or redemption, the "earned" discount realized is in lieu of interest and therefore is ordinary income.

Non-discount Obligations Can Also Give Capital Gain

If regular interest-bearing obligations such as notes, etc., are owned with a basis of less than face value, the redemption of the obligation will result in ordinary income to the extent of the difference. However, there are two ways of having the income changed into long-term capital gain:

1. Have the corporation convert the obligation into the required registered form before maturity. The subsequent redemption will then qualify the gain as a capital gain. The bonds don't have to be in the required form either when originally issued or when purchased by the particular creditor.

2. Sell the obligation to a third party. If the sale is made near maturity, the sales price will be approximately the same as the face value. Yet the proceeds will then receive capital gains treatment. The *sale* of a capital asset results in capital gain, while the redemption gives rise to ordinary income.

The purchaser of the obligation suffers no tax detriment. His basis is the purchase price and the only tax he will have to pay will be on the relatively

More Problems in Realization of Income as Long-Term Capital Gain

small difference between the face or redemption value and the purchase price.

Raise Sales Price, Lower Interest Rate

Another means of converting interest into capital gains occurs when property is sold with payment to be made in cash plus notes, mortgages, etc. The interest received on the obligation is fully taxable ordinary income, even though the actual sale may have given rise to capital gain.

To the extent that the interest payments are reflected in a higher sales price, the result is to change ordinary income into capital gain. For example, a building is sold for \$200,000 with \$50,000 down and a \$150,000, 10-year, 5% purchase money mortgage. The interest on the \$150,000 will be fully taxable. However, if the sale had been made for a higher sales price without interest on the unpaid balance the entire income would be capital gain.

The one "rub" here is that the seller's goal may collide with the buyer's goal. The seller wants his interest merged into the sales price. The buyer may want his interest payments separated from the purchase price in order to obtain a deduction for the interest. But the interests need not always conflict. If the buyer can obtain a similar benefit through depreciating or amortizing a higher basis, he may not object. If there is a conflict, the party in the higher tax bracket may be able to adjust the price in order to compensate the other (buyer or seller) for adopting his tax method.

While there is undoubtedly an interest factor in this arrangement, the courts and the Treasury have made no attempt to separate out the interest where the contract is silent on this point. As a matter of fact, where purchases are made on the installment basis, an interest deduction is allowed only where the contract specifies interest. But don't have the contract specify that the purchase price includes

interest. If it does, the interest factor may be separated out.

Dividends

To the individual stockholder, the receipt of dividends is fully taxable income. But there are a number of ways in which earnings may be obtained at a capital gains cost.

1. If stock bears a substantial dividend declaration, a sale of the stock before it goes ex-dividend results in a capital gain on the sale. The stock can be repurchased immediately after the stock goes ex-dividend. The "dividend" becomes a long-term capital gain.

2. A closed corporation which redeems stock of its stockholders, transfers funds to the stockholders in the same manner as if a dividend had been paid. Yet, if the redemption qualifies as a partial liquidation, the transaction is treated as a sale of the stock and results in capital gain rather than ordinary income.

The major obstacle to using this approach is the Treasury attitude that virtually all pro-rata redemptions are dividends. This problem is discussed more fully by Mr. Rich.

3. Stock with heavy arrears of dividends can saddle stockholders with a substantial amount of ordinary income if the arrears are paid up. The sale of the stock before the record date, even though the dividends are already declared, will result in capital gain. The dividends will be reflected in the higher sales price.

4. Another means of obtaining earnings at a capital gains cost is more drastic than the above. This is to liquidate a corporation completely. The gain on a corporate liquidation is capital gain even though all of the earnings and profits of the corporation are distributed. The piece-meal distribution of earnings over the years as dividends is fully taxable. The redemption of stock may also (as mentioned above) lead to a dividend attack. But the complete liquidation of a corporation

is one safe way of taking all earnings and profits out of the corporation at a capital gains cost.

One pitfall to watch in arriving at a decision is the problem of good will. If the Treasury can find that one of the unrecorded assets is good will, the cost of liquidating may be prohibitive. If the corporation is a "collapsible corporation" the gains may be ordinary income. This is discussed in Mr. McNeil's paper.

Buying Deductions via Capital Gains

Another way of converting income into capital gains is to obtain a stepped-up basis, at a capital gains cost, which can be used as a full reduction of ordinary income in the current and future years. If the increased basis can't be used immediately to cut income, the tax paid for the higher basis becomes an investment in future savings. The expected tax savings can often make this a profitable investment.

This can be accomplished in a number of ways: The most common and the one which gives taxpayers a "have your cake and eat it too" situation is to sell depreciable property which has appreciated in value to a controlled corporation. Under those conditions, control is never lost. And of course there is freedom of action in setting prices and terms—subject to a Treasury determination as to whether the property is "worth" the sales price. By providing that the sales price be paid in installments, the tax outlay by the individual may roughly coincide with the tax saving of the corporation.

Let's assume that A and B own a patent which is now worth \$100,000 but has a basis to them of zero. They also have a corporation engaged in business. If they sell the patent to the controlled corporation they will realize a capital gain of \$100,000. But the corporation will be able to amortize the \$100,000 cost over the remaining life of the patent. The result is that

\$100,000 of income is changed from ordinary income to capital gain.

80% Ownership Can Void Tax Benefit

The Treasury tried to block this tax saving device by Congressional action. But while it did get a law change, Congress so watered down the bar as to encourage the use of this tax saving method rather than block it.

A sale between an individual and a corporation results in ordinary income only if the individual, his wife and minor children and grandchildren own more than 80% in value of the outstanding stock. Ownership is not determined by any reference to indirect ownership through any other members of the family or through partnerships, corporations, etc. Thus, if two brothers own a 50-50 interest in a corporation, the sale of depreciable property to the corporation is not barred from capital gains treatment. A person can avoid this pitfall by the simple process of giving an adult child a 20% interest in the corporation.

This provision applies only to depreciable property. A jacked-up basis can be obtained for *depletable* property even though the corporation is owned 100% by the seller of the property.

Inter-family Sales

A result similar to that obtained by selling property to a controlled corporation can be obtained by making sales to relatives. Unlike losses, gains are recognized despite the relationship. While a sale to a spouse of depreciable property is specifically barred from capital gains treatment, sales to any other relative can result in a capital gain. While a sale of this kind may not permit the continued control as in the case of a controlled corporation, it does allow the property to be kept in the family. It also permits a gift (subject of course to any gift tax) to be combined with a personal income tax saving by selling somewhat below market price.

More Problems in Realization of Income as Long-Term Capital Gain

Let's assume a person owns a 10-year leasehold which returns him \$10,000 a year. Because of his high tax bracket, he has only \$4,000 a year left. He sells the leasehold to his son for \$60,000. Since this is a long-term capital gain, he has \$44,400 left after capital gains taxes of \$15,600 (26% of \$60,000)—more than he would have if he had kept the leasehold for 10 years. The son on the other hand will receive \$100,000 over the ten years, but he will pay tax on only \$40,000. Because of the son's lower tax bracket he will have to pay, say 35% of the \$40,000, or \$14,000. Total taxes paid by father and son would be \$29,600 on the whole \$100,000 instead of \$60,000 without the sale. Yet the father has also transferred \$26,000 (\$40,000—\$14,000) to his son.

Liquidating Corporation

Dissolving a corporation can give a tax benefit paralleling that obtained when a sale is made to a controlled corporation. Complete control is retained over the property and yet a jacked-up basis is obtained for the assets at the cost of a capital gains tax. Unlike the sale to a controlled corporation there are no statutory bars to capital gains treatment because the corporation is owned by one stockholder. However, there is a danger if the corporation qualifies as a collapsible corporation.

Let's take a corporation with its buildings and equipment depreciated down to a low level at a time when inflation has increased the value of the property. If the corporation liquidates, the stockholders will pay a capital gains tax based on the value of the property. But the basis to them will become the value, and this can be depreciated over

the remaining life expectancy of the property. A little mathematical calculation will show whether the cost is worth the saving.

Sell and Repurchase Similar Property

Still another means of obtaining the same tax benefit is to sell appreciated depreciable property and repurchase similar property. This can occur either because the property has appreciated in value, has been depreciated below its value or a combination of both.

Here are a few examples which explain this:

1. An automobile which is worth \$2,500 has been written down to \$1,000. A sale of the car for \$2,500 and the purchase of another car for \$2,500 gives a \$1,500 capital gain. However, depreciation can thereafter be taken on \$2,500 rather than \$1,000.

2. You own \$30,000, 5% corporate bonds due in 1957, which cost you par but which you can sell for over par—say \$32,000. If the bonds are sold for \$32,000 and then later repurchased for the same amount, the \$2,000 is long-term capital gain. But the bond premium can then be amortized pro-rata over the remaining years till maturity and deducted in full.

3. Building or equipment is depreciated at an accelerated rate through the use of the declining balance method. When the depreciation begins to fall off drastically, the property is sold and other property repurchased. Since the depreciation taken can often be faster than the drop in value, the difference will be converted into long-term capital gain by the sale. A higher basis for future depreciation will be obtained from the purchase at a higher price.



Problems in Estate and Gift Tax Planning

By LEONARD PRICE, C.P.A.

ALTHOUGH more and more taxpayers have come to realize the need for estate planning, all too few recognize the service which their accountants can render in this field. They turn to their attorneys, their insurance underwriters and investment counsel, but frequently overlook the fact that with respect to one of the most important aspects of the problem, that of tax minimization, the accountant is well equipped to contribute to the formulation of an effective estate plan.

Estate plans must be designed for the particular state of facts under consideration. No two estates will be exactly alike in composition and no two individuals will have identical views as to testamentary disposition. Large and involved estates may lend themselves to complex plans and the use of tax-saving devices which would not be practical for smaller estates. This paper is addressed to a consideration of some of the more general principles of tax

minimization applicable to estates of all sizes.

Gifts

The most obvious way of minimizing estate taxes is to reduce the taxable estate and the simplest way to do this is to dispose of property during one's lifetime. Assuming that the transfer is outright or, if in trust, meets the requirements imposed by law, and is not in contemplation of death, the property involved will not be subject to estate tax. Even if a gift tax is payable this will usually be outweighed by the estate tax savings. The following are some of the ways in which such savings may be accomplished:

(1) Gifts of \$3,000 may be given each year to as many individuals as the taxpayer wishes, free from tax, provided that the gift is of a "present" rather than a "future" interest. In the case of a married individual this amount is automatically doubled if his spouse consents. Thus a simple plan of reducing an estate is to adopt a program of such tax-free annual gifts.¹

(2) Gifts of \$30,000 (or \$60,000 in the case of a married person) in excess of the aforementioned annual exclusions may be made during one's lifetime. Thus a married man whose net estate would have been \$500,000 can save approximately \$9,000 in estate taxes by making a gift of \$66,000 without any gift-tax cost.²

(3) Gifts in excess of the gift tax exemption will produce tax savings. This is so because

- (a) The gift tax rates are $\frac{3}{4}$ ths of estate tax rates.
- (b) The gift tax is computed at progressive rates starting from

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¹ While such program might be challenged as having been in contemplation of death, the risk is substantially reduced by the three-year rule set forth in Sec. 811(l) I.R.C.

² The tax savings are figured after giving effect to both estate and gift tax marital deductions, but do not include the savings of estate tax to the spouse's estate.

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zero, whereas the saving in estate taxes by reason of a gift is effected at the top estate tax brackets.

(c) The gift tax paid is itself a reduction of the estate.

Thus, a married man whose net estate would have been \$500,000, who makes a gift of \$106,000 (\$40,000 in excess of the gift tax exemption and exclusion) will reduce his estate tax by approximately \$15,000, at a gift tax cost of only \$2,400.²

(4) Taxpayers in high income tax brackets will save tax on the income produced by the gift property, since, in most instances, the donee's income will fall into much lower brackets. In this connection consideration should be given to gifts in trust for the benefit of minors, providing for accumulation of income during minority, where the use of multiple trusts may produce a spreading of the income over low income tax brackets. (This consideration is also applicable to testamentary trusts and provision should be made in the will creating a separate trust for each beneficiary and providing prompt setting aside of the principal of the trusts.)

(5) Non-income producing property of high value, such as paintings and other art objects, which may be heavily taxed in the estate, and which may be of little use to the beneficiaries, can be given to charity free of tax. While this may be done by will as well, the *inter-vivos* transfer will produce an income tax benefit by way of the deduction for charitable contributions.

(6) Where an individual is obligated to support someone, a gift of income-producing property in trust will accomplish his purpose and at the same time save both estate and income taxes.

(7) Although gifts in contemplation of death are subjected to estate tax (with appropriate credit for the gift tax paid), such gifts are sometimes

beneficial tax-wise because the gift tax paid is excluded from the estate.³

The choice of property to be given away, if a choice exists, will also furnish the accountant with an opportunity to give sound advice. The following generalizations usually apply:

(1) Gifts of income-producing property will result in income tax savings if the donor is in high income tax brackets.

(2) As between identical lots of appreciated property with unequal tax bases, the high basis property should be chosen for the gift. This is so because in the case of a gift the donor's basis persists for computation of gain in the hands of the donee. The basis of retained property is automatically stepped up to the value at the date of death (or optional valuation date).⁴

(3) Similarly, property having growth or appreciation potentialities should be given away. The gift tax is computed on the present value. The estate tax would be computed on a much higher value if the anticipated appreciation occurs.

(4) Where a business interest is to be the subject of a gift, consideration may be given to the establishment of a charitable foundation to be the donee, so as to retain control.

(5) Where stock of a closely held corporation is being given away, problems of valuation and retention of control may arise. The accountant should consider the advisability of recommending the creation of new stock by way of tax-free reorganization or tax-free stock dividend to provide the proper medium for the gift. If valuation is a concern, a new preferred stock whose value for gift tax purposes will be par may be desirable. If control is a problem, a new non-voting stock may be the solution. Where the valuation of equity stock may be disputable, because of goodwill factors, consideration

³ See: Sec. 936(b) I.R.C. Because of involvements in the computation of the credit and the loss of stepped-up basis, such gifts should be in cash if possible.

⁴ See: Secs. 113(a)(2) and 113(a)(5) I.R.C.

should be given to the making of a small taxable gift of such stock so that a fair valuation for gift tax purposes may be reached with the tax authorities. Such gift tax valuation once agreed upon, while not conclusive, may be of strong evidentiary value later on when the stock must be valued for estate tax purposes.

Before leaving the subject of gifts, it is well to point out that the question is not entirely one-sided. There may be disadvantages which will outweigh the advantages. Some of such disadvantages are the following:

- (1) Gifts must be substantial to produce real savings.
- (2) Gifts may result in loss of needed income.
- (3) Gifts may result in loss of control of property.
- (4) Gifts should not reduce the estate to a point at which estate tax savings through estate tax exemption, marital deduction or low rates are lost.
- (5) If the donee predeceases the donor, the gift property might find its way back to the donor's estate and later be taxed therein.
- (6) If property must be sold to pay the gift tax there may be an additional capital gains tax.
- (7) The stepped-up basis of property when subjected to the estate tax is lost if it is transferred by way of gift.

The Marital Deduction

Since 1948 the law has afforded to married persons an opportunity to effect estate tax savings through the use of the estate tax marital deduction. Briefly stated, property includable in the gross estate which has passed or passes on death to the spouse outright or under certain specified conditions

is exempt from estate tax up to one-half the adjusted gross estate. In general, in order for property to qualify for the marital deduction in the first estate, it must be taxable in the spouse's estate upon her death.⁵

The tax benefits from the marital deduction are a matter of computation. Generally speaking, however, the following conclusions will apply:

(1) Whereas estates up to \$60,000 are exempt, an estate twice that size can be freed from tax by leaving one-half to the wife.

(2) Where the wife has no separate estate the marital deduction will always produce tax savings since, even assuming no subsequent disposition or consumption of the property, one-half the property will be taxed twice at lower brackets instead of the entire amount at progressively higher brackets.

(3) Where the wife has a separate estate the combined estate taxes on both husband's and wife's estate will be at a minimum if some amount less than one-half the adjusted gross estate is qualified for the marital deduction. (In general this amount is one-half the difference between the two estates, but there may be a wide range of amounts which will produce substantially the same combined tax.)

(4) Even where the maximum marital deduction produces a higher combined estate tax than some lesser amount, it may, nevertheless, be desirable to provide for it for one of the following reasons:

- (a) The surviving spouse may use up the property or dispose of it by gift thus avoiding the second tax.
- (b) The income earned on the taxes saved in the first estate during the life of the surviving spouse may exceed the tax detriment of having a larger amount of tax in her estate.

⁵ Throughout the discussion of the marital deduction the husband is assumed to be the decedent and the wife the survivor. All that is said applies equally to the reverse situation.

Problems in Estate and Gift Tax Planning

(c) Non-liquidity may necessitate keeping the tax as low as possible despite later tax costs.

Care must be exercised in some instances not to transfer to the wife more than the maximum marital deduction. Such excess, providing no tax benefit in the husband's estate, may later be taxed in the wife's estate. In such cases, if the taxpayer wishes his wife to have the benefit of the "excess" property, it should be left in trust for her in a non-marital deduction trust so that she may enjoy the income during life without tax of the principal on her death.

After the amount of desired marital deduction has been determined the manner of testamentary disposition must be considered. First, however, the amount of property passing to the wife outside the will such as life insurance payable to her or jointly-owned real estate, bonds, and so on, must be taken into account. The balance should then be provided for by will. Here a number of questions will arise. Should an outright bequest be made or should the property be left in a trust over which the wife has the requisite power of appointment to qualify it for the marital deduction? Should the will provide for bequest of a specific amount or a percentage of the estate? Should a so-called "formula clause" be used to assure the maximum marital deduction? If the wife's share is to come out of the residuary estate what provision should be made with respect to the apportionment of estate taxes? These are questions primarily for the client's attorney. The tax consequences of his recommendations are, however, a proper subject for the accountant's consideration.

Liquidity

Many estates consist primarily of non-liquid assets such as closely held business interests and real estate. Forced sale to meet tax payments may be costly. Liquidity, then, is a real fac-

tor in estate planning and tax minimization. It avoids the sacrifice of assets to pay taxes, avoids penalties or interest for delinquent payments and, on the other hand, permits savings through discount for prepayment of state estate taxes.

Let us consider some of the means of achieving liquidity of an estate:

(1) By keeping liquid during lifetime. (The accountant may make constructive suggestions as to how this may be accomplished.)

(2) By taking out life insurance payable to the estate. This is a most common form of estate planning, usually easy to accomplish and simple to arrange.

(3) By providing life insurance payable to a beneficiary who might buy assets of the estate.

(4) By creating a life insurance trust which can use the proceeds of the insurance to buy assets of the estate or lend them to the estate.

(5) By taking advantage of Sec. 115(g)(3), I.R.C., where the estate consists primarily of stock of a closely held corporation. This is primarily a step taken after death. However, in some instances, where there is more than one stockholder, it may be desirable to create an issue of non-voting stock during lifetime, to be retired after death, so as to avoid dilution of the estate's voting rights.

(6) By entering into buy-sell agreements with other stockholders or partners in a closely held business.

Valuation of Business Interests

Where the decedent was a stockholder or partner in a closely held business, his estate may encounter a serious problem of valuation. It is unnecessary to do more than allude to the question of goodwill which so frequently arises in these situations. Although valuation is primarily a problem after death, there is one protective step which may be taken during lifetime to

fix the estate tax valuation of a closely held business interest. This is the entering into of either a buy-sell agreement with one's partners or co-stockholders or a stock retirement agreement with the corporation. Such agreements, which may vary greatly in their provisions, provide for the purchase from one's estate of his stockholdings or partnership interest by the surviving stockholders or partners, or the retirement by the corporation itself of the decedent's stock. Where the sales price has been fixed absolutely, where disposition of the property was restricted during lifetime and where the entire agreement was negotiated at arm's length, the sales price should be binding for estate tax valuation. Thus, a difficult problem after death may be resolved in advance usually to the advantage of all stockholders or partners involved.

Such buy-out agreements must frequently be financed. The obvious means is life insurance. A number of alternatives with respect to such funding present themselves:

- (1) Each stockholder or partner insures his own life (and pays the premiums) for the benefit of the other stockholders or partners.
- (2) The corporation or partnership owns and pays the premiums on insurance on the lives of the stockholders or partners.
- (3) Each stockholder or partner insures the lives of the others and pays the premiums on the insurance owned by him.

The first plan is unattractive taxwise because of the premium payment test for determining the includability of insurance in the gross estate. Despite the highly inequitable result, the possibility exists that under this arrangement both the insurance proceeds and the value of the business interest would be taxed in the decedent's estate.

The second plan, known as the "entity ownership" plan, which is gen-

erally employed where there is a stock retirement plan has the virtue of simplicity of operation. One danger exists, however. Even though the decedent retained no incidents of ownership, it may be held that he made an indirect payment of the premiums. This is particularly so in the case of a partnership. The question has not been adjudicated so far as estate taxes are concerned. However, in a relatively recent case⁶ dealing with excess profits taxes the court gave its approval to so-called "key man" insurance for the purpose of stock redemption where the purpose was to insure continuity of corporate management.

The third plan, however, which involves cross insurance, if practicable, appears to be the safest. There is no ground for including the insurance proceeds in the decedent's estate since he had no incidents of ownership and payment of the premiums cannot be imputed to him directly or indirectly. Although this plan may involve unequal costs because of differing ages of partners or stockholders, the safety factor from the tax standpoint makes it the most attractive.

Life Insurance

Few estate plans are consummated without some use of life insurance either to provide protection, liquidity or as a means of funding. In the study of a client's estate, his existing life insurance should be the subject of close scrutiny. Even apart from the estate plan certain changes may be desirable. Endowment policies which upon maturity will produce taxable income may be converted before maturity to an option which will postpone the incidence of the tax to a time when the insured's income is less. Insurance payable outright to, or left at the interest option for the benefit of, a beneficiary in high income brackets (which will be costly income taxwise) may be changed to an annuity option which will free

⁶ *Emeloid Co., Inc. v. Commissioner*, 189 F. (2d) 230.

the proceeds from tax in the hands of the recipient. And even apart from tax savings, flexibility with respect to the use and enjoyment of the insurance proceeds may often be better achieved through the creation of a trust to which the proceeds will be paid. Broad powers granted to the trustees may assure the better administration of the fund and wiser application to the needs of the beneficiaries.

Under the present provisions of the law⁷ life insurance is wholly includable in the gross estate if any of the following conditions are met:

- (1) It is payable to the insured's estate.
- (2) The insured had any incidents of ownership at his death.
- (3) The insured paid all of the premiums (either directly or indirectly).

Where the insured paid only part of the premiums the proceeds are includable in his estate in the proportion that the premiums paid by him directly or indirectly bear to the total premiums paid.⁸

As has been indicated earlier in this paper, life insurance is frequently the subject of gift. In many instances this is the only property available for the purpose. In planning such gifts it should be remembered that the assignment of life insurance on the donor's life provides only a partial exemption from estate taxes because of the premium payment rule. Moreover, where this is done the insured must divest himself of all incidents of ownership and the payment of subsequent premiums by the assignee must be from his (or her) own funds and must not be traceable to the insured. If the assignee has separate property out of which the premiums may be paid, there is no problem. But where, for example, a

husband assigns an insurance policy to his wife and then supplies her with the funds to pay the premiums, either by gift or otherwise, the exclusion of a portion of the insurance proceeds from his estate will be challenged.

A common method of carrying insurance policies is in a funded insurance trust. The grantor transfers to the trust insurance policies and income-producing property with direction to the trustee to use the income to pay premiums. The income tax consequences of such arrangements are fairly well settled.⁹ However, although the estate tax consequences are less clearly defined, it may be claimed that the premiums were paid indirectly by the insured and that the insurance is therefore includable in his estate.

To avoid the problems incident to the transfer of existing policies, plans are frequently devised whereby new insurance on the taxpayer's life is taken out by his wife, a child or other relative. Such procedure will eliminate the possibility of the insurance being taxed in the insured's estate, providing the premiums are paid out of separate funds of the owner of the policy. If such new insurance is contemplated it must be borne in mind that if the owner predeceases the insured, the cash value of the policy will be included in the owner's estate. Further, in such cases provision should be made for the payment of premiums after the owner's death; this is usually done through the creation by the owner of a testamentary trust for this purpose. Where, as sometimes is the case, a wife takes out insurance on her husband's life and provides that the proceeds shall be paid to their children, it has been held that upon the death of the insured there was a completed gift of the proceeds from the wife to the children.¹⁰ Such gift imputation can probably be avoided

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⁷ See Sec. 811(g), I.R.C.

⁸ Where the insured had no incidents of ownership prior to January 10, 1941, premiums paid by him prior to that date are not taken into account in the proration.

⁹ See Sec. 167(a)(3), I.R.C.

¹⁰ See *Goodman v. Commissioner*, 156 F. (2d) 218.

Problems of the Estate after It is Created

By WILLIAM K. CARSON, C.P.A.

THE major tax problem of the estate after it is created is, of course, the determination of the estate tax liability. In this field the services of the accountant can be particularly beneficial. The foundation for the filing of the estate tax return is laid by compiling an inventory of the assets and a list of the liabilities of the estate. After completion of the inventory, it is necessary to value the assets for the purpose of determining the gross estate. The problems most frequently encountered in this determination relate to the optional valuation date and the valuation of closely held companies.

Section 811(j), permitting use of the optional valuation date, was added to the Code to avoid the inequity which was brought about when falling security prices made it impossible for the executor to realize on the securities in an estate's portfolio at prices as high as those on which the estate tax was based. To alleviate this situation, the estate may be valued as of a date one year after the date of decedent's death. Two rules must be remembered in connection with the optional valuation: (1) any asset which is disposed of before the optional valuation date, either by distribution in accordance with the terms of the will, or by sale or ex-

change, is to be valued at the date of disposition, and (2) no consideration is given to a difference in value which is due solely to the lapse of time. If it is found desirable to use the optional valuation date, an election to do so must be included in a timely filed return.

If the values of assets included in the estate fall below the value at date of death and the decline appears to be temporary, consideration should be given to a distribution of assets to the beneficiaries, followed by an election to use the optional valuation date. The assets will be valued on the date of distribution, and if the executor's conclusions as to the market trend are correct, there will be a saving in tax.

Ordinarily the option is only exercised to effect a saving in estate taxes, where values have dropped. However, when values have gone up, consideration should be given to use of the option to save income taxes on sale of the property.

This saving comes about because the basis of property passing through an estate in which the optional valuation date is used is the value on that date. If securities are sold at a profit within six months of the date of death, it will frequently be found that the saving in income taxes will exceed the increase in estate taxes resulting from the use of the optional valuation. In small estates, even the low rate of income tax on long-term gains may also exceed the estate tax rates. Similarly, the optional date may be used to step up the basis in a case where most of the appreciated property goes to the widow, but the total which she receives is less than the limitation on the marital deduction.

If the assets of the estate include shares of stock for which quoted prices are not available, a difficult valuation problem is presented. Consideration

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must be given to a large number of factors, including the following:

- (1) Isolated sales.
- (2) Valuation of the underlying assets.
- (3) Valuation of goodwill by formula methods.
- (4) Comparison with quoted prices of listed companies in the same industry, or with representative listed stocks.
- (5) Consideration of the effect of leverage where debt or preferred stock is outstanding.
- (6) Application of the blockage rule where a large block of stock is to be valued.
- (7) Reduction by a discount in case the stock represents a minority interest in a closely held company.

An excellent case approving use of the comparison with listed companies in preference to valuation of the underlying assets is *Elizabeth A. Wilson Estate*, 10 T.C.M. 750.

When an estate has a scarcity of liquid assets, the executor is forced to search for ways and means of paying estate taxes. Frequently, the only possibility is the retirement of stock of a closely held company, owned by the estate. Ordinarily such a retirement is subject to tax only to the extent that the proceeds exceed the valuation of the stock for estate tax purposes. But depending on the facts, the retirement could be made in such a way that the Commissioner will contend that it is essentially equivalent to the distribution of a taxable dividend, and will attempt to tax it as such. Section 115(g)(3) was enacted to prevent this from happening when certain conditions are met. First the value of the stock of the company must exceed 35% of the value of the gross estate. Secondly, the amount which can be received without the possibility of treatment as dividend cannot exceed the federal estate tax. The latter computation is not made on an aggregate

basis for the entire estate. Rather, according to the Regulations, the amount which can be received by any distributee of the estate, and receive protection from this section, cannot exceed the estate tax chargeable against such distributee.

New problems are introduced into the preparation of the final income and gift tax returns of the decedent. Section 51(b)(3) permits the filing of a joint income tax return, and ordinarily this will result in a lower tax than separate returns. Similarly, gifts made between January 1st and the date of the decedent's death may be split between the donor and his spouse.

In preparing the income tax returns of the estate, it is necessary to include in income of the year when received all items of gross income in respect of the decedent. Under Section 126, such items do not acquire a basis nor are they changed from ordinary income to capital gain because of decedent's death. Similarly, certain deductions and credits attributable to the decedent are allowable to the estate in the year when paid. Where possible such deductions should not be paid in a year in which such income is received. This is because the estate receives a deduction in computing taxable income which is based on the excess of such income in any year over such deductions. The amount of the deduction is the amount by which this excess has increased the estate tax.

A choice is presented with regard to deduction of administration expenses. Deduction of this nature may be claimed either on the estate tax return or on the income tax return. Since the choice can be made annually, a new computation is required each year to see if a greater saving is obtained by deduction for income or estate tax purposes. If the former, a statement in the return is required by Section 29.162-1.

A saving in income taxes may be achieved through the timing of distributions of the income of the estate. Comparison should be made between

the top bracket of the estate and that of each beneficiary. Distributions to each beneficiary whose bracket is lower than that of the estate will save income taxes for everyone concerned. Similarly, if the will provides for creation of trusts, it may also permit income to be distributed to the trusts in advance of the time when it is administratively possible to transfer principal. Where the beneficiary's bracket exceeds that of the estate, but it is nevertheless desirable for him to obtain estate assets, a distribution of principal rather than income should be considered.

The final distribution of the estate income should normally be made more than 65 days after the close of a fiscal year. In this way the income taxable to the recipients is the income of a short period rather than that of the full preceding year.

Control should also be exercised over the timing of expenses. An example of an opportunity for this control arises when a large block of securities is sold at a gain and shortly thereafter a portion of the estate is distributed. If the state income tax is paid at the normal time it will be deductible for Federal income tax purposes in the following year when the income is greatly reduced and falls in lower brackets. This can be avoided by filing the state income tax return and paying the tax prior to the close of the fiscal year. Other expenses will also arise during the course of administration of the estate where there is a choice of year of payment, and therefore, selection of the year which has the highest tax rate will result in savings of Federal income taxes.



Problems in Estate and Gift Tax Planning

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if the insurance proceeds are left in trust and the wife retains a right of invasion.

One further arrangement frequently employed where both husband and wife have independent means should be mentioned. It contemplates the creation by one spouse (usually the wife) of a trust for the purpose of taking out insurance on the life of the other. Property sufficient to provide income in an amount necessary to pay the premiums is transferred to the trust and a gift tax thereon, if due, is paid. The trust then takes out the insurance which it holds for the benefit of others, usually the children. Under this plan

the insurance should not be includible in the estates of either spouse and there should be no gift tax on the proceeds of the insurance. This arrangement should not be entered into on a reciprocal basis, however. Under such circumstances it may be held that each spouse in effect provided the property out of which the insurance premiums on his own life were paid.¹¹

It will be seen from the foregoing brief analysis that estate plans require the most careful study and consideration and that, with respect to any proposed plan, the income and gift tax consequences should be as carefully investigated as the estate tax effects.

¹¹ See *Lehman v. Commissioner*, 109 F. (2d) 99; cert. den., 310 U. S. 637.

Problems in Real Estate Transactions

By ARTHUR B. MOLL, C.P.A.

MANY of the problems which have arisen in connection with transactions involving real estate have clearly resulted from a lack of previous consideration of the tax consequences. The client should be educated to co-operate with his accountant, first by a full and free discussion of the tax factors involved, before the transaction is completed, and second, by obtaining and keeping a complete record of all the data necessary to prove any and all points in support of the tax return information filed.

Once having obtained the co-operation of client, it then remains for the accountant to give orderly consideration to the many points involved. This paper outlines the points to be considered and indicates some of the problems which have given trouble to other taxpayers in recent years.

Unadjusted Basis

Section 113(a) of the Internal Revenue Code tells us that the basis of property is the cost of such property, with certain numerous exceptions.

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Many of these exceptions need not concern us here, but the more important ones pertinent to our subject are the following:

Property acquired by gift after December 31, 1920, has the same basis as it would in the hands of the donor, except that if such basis is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value.¹ The obvious problem here is the one of determining the donor's basis. The Code permits the Commissioner himself to determine such basis, or the fair market value at the date of gift. Obviously, the taxpayer is at a distinct disadvantage unless he himself can produce the records supporting basis or value. A recent Court decision, although not one involving real estate, denied a loss to a taxpayer who had gift property stolen from him, but who could not prove the donor's basis or the fair market value at the time of the gift.²

If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a gift, bequest or devise) the basis is the same as it would be in the hands of the grantor, increased by the amount of the gain or decreased by the amount of the loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made.³ The distinction here is rather fine, but should be mentioned for the record.

If the property was acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent, the basis is the fair market value of such property at the time of such acquisition (which acquisition is deemed to be the

¹ I.R.C., Sec. 113(a)(2).

² *Danziger, Memo. T.C.*, Docket No. 33298, October 3, 1952.

³ I.R.C., Sec. 113(a)(3).

date of death).⁴ An exception to this rule exists where an election was made to value the property of the decedent as of the optional valuation date for estate tax purposes. In such case, the basis of the property will be the optional value (but the date of acquisition is still the date of death). Special rules exist in establishing the basis of property to a surviving spouse of his share of community property. Of course, the big problems here are ones of valuation, and they are many and varied. The taxpayer is well advised to fortify himself with unquestionable proofs of value.

Where property was received in a tax-free exchange, the new property takes the basis of the property given up in the exchange. These exchanges under Section 112 were not intended to make the exchanges free of tax, but merely postponed the tax until a later date. Money, or other "boot" received as part of such an exchange will reduce the basis only if it is not taxed then.⁵ Under this section, when property received in an exchange takes the place of property previously held, the law requires proper adjustments for depreciation during the time the original property was held. It should be noted here that this section refers to the present law in describing the types of transactions to which it applies, but invokes the law applicable to the year in which the exchange was made, in order to determine the amount of the adjustment to be made to the basis of the property originally held.

In order for property to come under this tax postponement section, it must be held for productive use in trade or business, or for investment. A personal residence is not considered investment property by the Commissioner,⁶ but Section 112(n) of the Code (which

was added by the Revenue Act of 1951) gives this type of property special treatment, which will be covered later in this paper. Property, to come under this tax-free exchange section, must be of "like kind" by reason of its character rather than its grade or quality. In most cases, a lease for 30 years or more is considered real estate and may be exchanged tax-free.⁷

If the property exchanged is mortgaged, the amount of the mortgage is considered cash received by the transferor of the mortgaged property, whether or not the mortgage is assumed by the transferee. Where there are mortgages on both properties, the net difference in mortgages is considered cash received.⁸ In both cases, gain will be recognized to the extent of such "cash".

Property acquired by a corporation in connection with a reorganization requires the use of the transferor's basis.¹⁰ This section of the Code makes it mandatory to increase the basis by the amount of gain or decrease the basis by the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which such transfer was made. Thus, the reorganization need not be completely tax-free. A word of caution here to the corporation which intends to buy the stock of another corporation for the purpose of acquiring the property owned by that corporation. If the price paid for the stock exceeds the basis of the property in the hands of the acquired corporation, such excess cannot ordinarily be added to the basis of the property if the acquired corporation is liquidated for the purpose of transferring the property to the acquiring corporation.¹¹ However, in a recent case involving acquisition of assets following an involuntary conversion, the

⁴ I.R.C., Sec. 113(a)(5).

⁵ I.R.C., Sec. 113(a)(6).

⁶ I.T. 1587, II-1 C.B. 26.

⁷ Reg. 111, Sec. 29.112(b)(1).

⁸ *Brons Hotels, Inc.*, 34 B.T.A. 376; *Ebert Estate*, 37 B.T.A. 186.

⁹ I.R.C., Sec. 112(c)(1).

¹⁰ I.R.C., Sec. 113(a)(7).

¹¹ I.R.C., Sec. 112(b)(4), Sec. 113(a)(15).

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Commissioner was upheld in his contention that where a corporation replaced its plant that was destroyed by fire by purchasing all of the stock of another corporation and then liquidating that corporation to obtain its plant, the two steps (i.e., the purchase of the stock and the liquidation of the acquired corporation) were not separate. Thus, the price paid for the stock was used in figuring the basis of the transferred property.¹² In the *Prairie Oil and Gas Company*¹³ case, even though the buying corporation first purchased the stock and then dissolved the corporation which owned the properties, it was permitted to use the cost of the stock as a basis, rather than the lower basis in the hands of the acquired corporation. Here, and in all the cases which followed this case, the entire transaction was considered, rather than the component parts, and it was recognized that the price paid for the stock really was the cost of the properties. It is hoped that his conflict will be corrected by legislation, and to that end the American Institute of Accountants has recommended to the Treasury Department that the Code be amended. Your attention is called to Public Law 251, October 31, 1951, which amends Section 112(f) to permit the purchase of stock to get control of a corporation owning property which can be used as replacement property in an involuntary conversion.

While on the subject of involuntary conversion, it would be well to note that in the case of property purchased by the taxpayer which resulted in the non-recognition of gain under the rules of Section 112(f)(3), the basis of the property shall be the cost less the amount of the gain not so recognized. Allocations are required where more than one piece of property is involved. The old requirement that the proceeds of an involuntary conversion be

"traced" directly to the acquisition of replacement property has now been liberalized to remove some of the hardships thereby caused. Now it is possible to purchase replacement property prior to the actual condemnation. The imminence of a condemnation is now enough for a prudent taxpayer to set the wheels in motion to acquire replacement property without the former penalty of having a taxable gain recognized. These rules, however, are effective for dispositions which occurred after December 31, 1950. If the proceeds were received after December 31, 1950, for a disposition which occurred before January 1, 1951, the old rules still apply.¹⁴ "Dispositions", as used here, are defined as condemnations, thefts, seizures, destructions or requisitions of the converted property.

Problems of the basis of property contributed to, or distributed by a partnership, covered in Mr. David Zack's paper, have not been discussed herein. Property that was received by a stockholder in liquidation of a corporation has as a basis the fair market value of the property at the time of the liquidation.¹⁵ This is the ordinary rule and of course there are exceptions such as the distributions in kind under Section 112(b)(7) and the liquidation of a subsidiary under Section 112(b)(6).¹⁶

Property which has been acquired by the foreclosure of a mortgage ordinarily has as its basis the fair market value at time of foreclosure. The determination of what is fair market value, and the influence of the bid price at time of foreclosure is one of the chief problems to be carefully considered. The record of previous rulings and cases should be examined in each individual case under consideration.

Where mortgaged property has been received in a voluntary conveyance by the mortgagee from the mortgagor in

¹² *Kimball-Diamond Co.*, 14 T.C. 74, affirmed (5 Cir., 1951), cert. den.

¹³ *Prairie Oil & Gas Co., v. Motter*, 66 F. 2d. 309.

¹⁴ I.R.C., Sec. 113(a)(9).

¹⁵ I.R.C., Sec. 115(c)(1).

¹⁶ I.R.C., Sec. 113(a)(15).

settlement in lieu of foreclosure, the basis of the property in the hands of the mortgagee is the fair market value at time of conveyance. The problem of valuation can be eliminated by paying a small amount for the deed. The cash paid plus the mortgage then becomes the basis.

In passing, it should be pointed out that where property is purchased, the amounts of all mortgages, whether assumed or not by the purchaser, become part of the cost basis. Where property is purchased subject to mortgages and thereafter the purchaser obtains a cancellation of all or part of the mortgages, the basis shall be reduced by the amount of the cancellation. The same rule holds for cancellation of purchase money obligations.

Adjusted Basis

Up to this point we have considered the "unadjusted basis" of the properties. Certain adjustments are required to arrive at the "adjusted basis", and these will be considered in brief outline. Section 113(b) of the Code requires the addition to basis of all items properly chargeable to capital account, such as costs of acquiring title; costs of defending or perfecting title; real estate taxes which were a lien at the time of acquisition; demolition costs not otherwise deducted; abandonment costs not otherwise deducted; costs of permanent improvements; architects' and engineering fees. If an election under Section 24(a)(7) of the Code was made to capitalize taxes and carrying charges, then of course these must also be added to the basis. This situation occurs mainly in its application to unimproved property and covers such items as mortgage interest, development expense, and interest on loans for development and construction as well as current real estate taxes.¹⁷

As a general rule, reduction of basis is required for depreciation, obsolescence and depletion to the extent that these items were allowed or allowable as deductions in computing net income. The general rule has been modified by Public Law 539, July 14, 1952, which is retroactive, at the taxpayers election, to open taxable years beginning after December 31, 1938. The new rule provides that if for any taxable year, the depreciation "allowed" is in excess of the depreciation "allowable", the excess need be applied to reduce basis only to the extent that the deduction of the excess amounts reduced income or excess profits taxes for any year. This amendment was intended to correct the inequitable situation created by the decision in the *Virginian Hotel* case,¹⁸ but there still remains the problem of resolving the differences of opinion with the Commissioner as to just what amount of depreciation is "allowable." The election under the new amendment had to be made not later than December 31, 1952.¹⁹

If a property owner sells an easement to which no specific part of the basis of the entire property can be allocated, the proceeds received on such sale must be applied as a reduction in the basis of the property.²⁰

Method of Sale and Reporting

When property is owned by a corporation, proper planning of a possible future sale can give substantial tax savings. This is particularly true of real estate which is owned by a corporation in the situation, not unusual, where there is virtually no other property. A sale by the corporation results in a capital gain, and a tax is paid thereon. Then if the corporation is dissolved in order to get the proceeds of the sale into the hands of the stockholders, there is another tax on the gain to the stock-

¹⁷ Reg. 111, Sec. 29.24-5.

¹⁸ *Virginian Hotel Corp. of Lynchburg, Va., v. Helvering*, 319 U. S. 523.

¹⁹ I.R.C., Sec. 113(d) and I.R.C., Sec. 113(b)(1)(b).

²⁰ *Inaja Land Co.*, 9 T.C. 727 (1947).

Problems in Real Estate Transactions

holders. The obvious means of avoiding the double tax are either (a) to sell the stock of the corporation, or (b) to liquidate the corporation, distribute the property to the stockholders and have the stockholders make the sale. The second procedure has had the approval of the United States Supreme Court, but it does have its problems which should be carefully considered.

First of all is the avoidance of the trap of starting sale proceedings by the corporation before dissolution. The often-quoted *Court Holding Co.* case²¹ taxed such a gain to the corporation. Proper handling of such a situation can result in a decision favorable to the taxpayers, such as in the *Cumberland Public Service Co.* case.²² If it is desirable to make the sale by means of a corporation liquidation, then by all means study these cases and bring the facts within the rule of the *Cumberland* case and assemble at the time of the transaction all data necessary to prove such facts.

But now consider the possibility that the stockholders might out-smart themselves by a corporate dissolution and later sale of the property by themselves. Consideration should be given to the use to which the funds are to be put. Is it intended to reinvest in another parcel of real estate? Then why not let the corporation make the capital gain and leave the proceeds in the corporate name to be further reinvested. Of course the question can be raised as to how many times can this be done before the corporation will be classed as a dealer in real estate, with the gains no longer taxable as capital gains. The frequency of the transactions will probably control.

The most direct way of disposing of corporation-owned real estate without double taxation is by the sale of the stock in the corporation. There are problems to be overcome here however. First and foremost is the one of inducing the buyer to buy stock rather than

property, particularly where the price of the stock is based on a valuation of the property in excess of the basis of the property in the hands of the owning corporation. There should be no great difficulty where the buyer is an individual or a partnership, because the buyer can immediately dissolve the corporation and take over the property at a value based on the purchase price of the stock. But, where the buyer is a corporation, there is, as was heretofore pointed out, some question as to whether the buyer can get a stepped-up basis for the property by an immediate liquidation of the acquired corporation. Assuming that the buying corporation decides that it can get the stepped-up basis, how does one handle the situation where the vendors (i.e., the stockholders of the transferred corporation) are willing to take as part of the selling price a purchase money mortgage on the real estate? Perhaps the following steps provide a solution!

Step One: Buyer and Seller (i.e., the stockholders) agree on a purchase and sale of the stock of the transferred corporation on the following terms:

- (a) The sale of the stock is to be an installment sale.
- (b) Seller wants the stock held as collateral to secure the deferred portion of the selling price.
- (c) Buyer cannot liquidate the corporation or mortgage the property without the seller's consent.

Step Two: The buyer liquidates the corporation (by consent of seller) and gives the seller a mortgage on the property which the seller holds as collateral for the deferred portion of the selling price.

Control of Method and Period of Reporting

There are a number of ways by which the seller of real estate can control the method and period of report-

²¹ *Court Holding Co. v. Comm.*, 324 U. S. 331.

²² *Cumberland Public Service Co.*, 338 U. S. 451.

ing the gain. The selection of a closing date can put the gain in one year or another in many cases where the transaction occurs near the end of the taxable year. By giving the prospective buyer of the property an option to be exercised at a later date, the gain can be postponed until the option is exercised. If the seller protects himself by requiring a substantial option payment, the receipt of the option payment will not give rise to taxable income.²³ However, if the option payment is forfeited the amount thereof is short-term capital gain in the year of forfeiture.²⁴

If the contract of sale is drawn to provide that the purchase price is to be placed in escrow, and paid only on fulfillment of certain conditions, the gain can be postponed until the conditions are met. This is true whether or not the taxpayer is on a cash or accrual basis.²⁵ It is important that the seller has no control over the escrow funds.

In addition to these methods of controlling the period of reporting the gain, the seller of real estate has a choice of methods of reporting. These are the straight cash method (which under some circumstances might be desirable), the installment method of reporting, and the deferred payment sale. The cash method requires no extensive discussion. The taxpayer's circumstances very often make it unnecessary to postpone the capital gains tax, particularly in sales for all cash and where the taxpayer is in higher brackets.

Use of the installment method may in many instances be highly desirable. Such method can reduce the tax and also postpone its payment until the proceeds of sale are received over each of the years involved. In order for a sale to come under the installment sale provisions, two requirements must be met.²⁶ There must be some initial payment in the year of the sale, which

should be cash or property other than evidence of indebtedness of the purchaser. Furthermore, the initial payment may not exceed 30 per cent of the total purchase price. Purchase price includes the existing mortgage on the property, whether or not assumed by the purchaser. You are reminded that the initial payment includes any installment payments made in the year of sale as well as the down payment at the time of sale, and if the total of these exceeds 30 per cent, the installment method of reporting is not permitted. The amount by which the mortgage on the property exceeds the basis to the seller is also considered to be the equivalent of cash received and must be included in the initial payment. If more cash is needed, it is possible to sell the purchase money mortgage or the buyer's notes without increasing the amount of the initial payment, or an installment in the desired amount can be made payable early in the year following the year of sale. Where the seller is a corporation, it can transfer the installment obligations to the stockholders as a liquidating dividend. The installment obligations on liquidation are then taxed to the corporation by valuation on date of distribution.

A deferred payment sale is one that cannot qualify as an installment sale because of the initial payment rule, but nevertheless does provide that part of the purchase price be paid in the future. In order to qualify, it must be shown that the evidence of the purchaser's obligation to make the deferred payments has no market value. A non-negotiable note has been held to have no market value.²⁷

In this event, the initial cash received is applied first to reduce the basis of the property and the gain is deferred until sufficient installments have been received to exceed the basis and the

²³ *Mary P. Hunter*, 140 F. 2d. 954.

²⁴ L.R.C., Sec. 117(g)(2).

²⁵ *Bedell v. Commissioner*, 30 F. 2d. 622.

²⁶ Reg. 111, Sec. 29.44-2.

²⁷ *Bedell v. Commissioner*, 30 F. 2d. 622.

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gains then are capital gains. It is possible that, where the evidence of indebtedness is negotiable, it may still have a market value of less than its face amount; in which case, the amount of the selling price is determined by including the note at its market value. However, where future collections of such an obligation are made, allocations must be made between the return of capital and ordinary income. Thus the amount of discount in the value of the obligation will be ordinary income when collected, and the procedure of receiving such notes should be followed with extreme caution.²⁸

A method of tax-postponement, not available to dealers, is one in which property held for productive use in trade or business, or for investment, is exchanged for property of like kind. The taxation of the appreciation in the value of the transferred property is postponed to the time of sale of the newly acquired property. The new property in these circumstances takes the basis of the property given in exchange. Where cash is received to adjust for the possible difference in values, gain will be recognized to the extent of such cash. It has been held, in one case, that where the property received in the exchange was sold after being held for only a short time, such property was not "property held for investment" and, consequently, the gain on the exchange was taxable.²⁹

Business Property and Section 117(j)

The special treatment accorded property which qualifies under Section 117(j) of the Code is one affording great relief to taxpayers. Here we have the fulfillment of the dream to tax ordinary income at capital gain rates but it is entirely equitable. Property, to

come under the rules of this Section must be held for over 6 months, and must be used in the trade or business of the taxpayer. It can not be property includable in inventory or held primarily for sale to customers in the ordinary course of trade or business.

This definition has caused many cases to come before the Courts. There is no one test which determines whether or not real estate is held primarily for sale to customers. Rental property ordinarily comes within the scope of the Section, but the facts in each case must be examined. A recent court decision held that gain on the sale of houses built for rental purposes was ordinary income when the sale was made under the special circumstances existing.³⁰ The usual test is whether the sales were frequent and continuous or isolated and casual. It is not necessary that the taxpayer be exclusively in the real estate business or devote a great deal of time to it, to disqualify himself from Section 117(j). The purpose of acquisition has little importance here. The circumstances at the time of the sale determine whether the seller is a "dealer." This entire matter is one which should be considered very carefully in light of the decisions and a complete study made of the facts of the individual case in question. Space here is too short to go into an extensive review of the decisions, but they should not be overlooked by the accountant confronted with a case involving a proposed sale of such property.

The Revenue Act of 1951³¹ made a change which permits the inclusion of unharvested crops with the land in computing capital gain. This settled the doubt which brought a number of cases to the courts, and although the more recent decisions held for such inclusion, the necessity of litigating the question has been removed.

²⁸ *A. B. Culbertson, et al.*, 14 T.C. 1421.

²⁹ *Regals Realty Co. v. Commissioner*, 127 F. 2d. 931.

³⁰ *Bildwell, Inc.*, Memo. T.C., Docket No. 36016, October 23, 1952.

³¹ Sec. 323(a), Revenue Act of 1951, amending I.R.C., Sec. 117(j).

Residential Property

Residential property is considered a capital asset, but a loss on a sale is not deductible. Under ordinary circumstances, a gain is taxed as a capital gain, but the Revenue Act of 1951 has set up special rules where the taxpayer has purchased a replacement property.³² If a taxpayer sells his principal residence and, within a period beginning one year prior to the date of such sale and ending one year after that date, purchases another property for use as his principal residence, the gain from the sale of the old residence is not recognized except to the extent that the selling price exceeds the cost of the new residence. If the new residence is constructed for the taxpayer, the construction must start within a year after the sale of the old residence, and it must be used within 18 months of such sale.

The amount of gain which is not taxed under this section reduces the basis of the new property, so that we have a tax-postponement. If gain realized from the sale of a residence is not recognized because of the purchase of a new residence, a taxpayer cannot, within one year after the sale of the old residence, again obtain the benefit of this section if he sells the new residence

and purchases still another. This does not include an involuntary conversion of the new residence.

The term "principal residence" does not include a country home, but may include a houseboat or trailer if used as the principal residence. A cooperative apartment is also considered the same as a residence and comes under the same rules.

Ordinarily, a loss on the sale of one residence cannot be offset against a gain on the sale of another. However, the operation of Section 112(n) does just that in the case of the sale of the new residence at a loss (although at a gain over the adjusted basis caused by the postponement of the gain on the sale of the old residence). If the loss came first, there would be no offset, and because of this we have an inequitable situation which should be corrected.

Public Law 567, July 16, 1952, grants relief to members of the Armed Services during the present emergency by suspending the running of the 1 year or 18-month period, for acquisition of a new residence, for the period of service. This extension runs to January 1, 1954, but in no event shall it extend beyond 4 years after the sale of the old residence.

³² I.R.C., Sec. 112(n).



New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Sales and Use Taxes—Exemptions

The New York City Sales Tax Law was amended as of July 1, 1952, eliminating the former exemption from the tax to semi-public institutions. Instead, the law now exempts from the tax transactions by or with the State of New York, public corporations created pursuant to an agreement with another state or the Dominion of Canada, improvement district or other political subdivision of the state where it is the purchaser, user or consumer. Exempt also are transactions with the United States, the United Nations or other world wide international organizations of which the United States is a member. There is a further provision for exemption from the tax to any corporation, association, trust or community chest organized and operated exclusively for religious, charitable or educa-

tional purposes or for the prevention of cruelty to children.

The latter provision is the familiar exemption found in many tax laws. It is conditioned on the fact that no part of the net earnings inure to the benefit of any private shareholder or individual, and that no substantial part of the activities of the organization consists of carrying on propaganda or influencing legislation. The exemption specifically excludes an organization operated for the primary purpose of carrying on a business for profit, even though all or some of the profits are payable to an exempt organization. Specifically excluded also are retail sales made by any store operated by a college, university or institution of higher education. The exceptions would appear to follow the changes made in the Internal Revenue Code in 1950, in Section 101(6). The organization claiming exemption must submit information to the Comptroller which includes the purposes for which it is organized, its actual activities, the sources and disposition of the income, a copy of the articles of incorporation, a financial statement showing assets and liabilities, a statement of the receipts and disbursements and a photostatic copy of the letter from the Treasury Department granting exemption from federal income tax under Section 101(6).

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Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving as one of the Vice-Presidents of the Society and is also on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Sales and Use Taxes— Information Services

The amendment to the sales and use taxes effective July 1, 1952, imposed a three per cent tax on receipts from the sale or use of information services. To be taxable the services must involve the furnishing of printed, mimeographed or similar matter. It includes

the services of collecting, compiling or analyzing information of any kind and furnishing reports to other persons. In the bulletin issued by the Comptroller he enumerates the types of information services subject to the tax. These include credit information, statistical, building and construction, stock market and advisory service, tax information, etc. Information services furnished to newspapers are not subject to the tax.

Since this amendment became effective on July 1, 1952, a contract for such information services entered into before and extending beyond that date is taxed in one of two ways. If the contract is payable in installments, the payments on and after July 1, 1952, are subject to the tax. If the price has been paid in advance, the tax is apportioned on the basis of the number of days in the contract period after July 1, 1952. Persons furnishing the information services will not be taxable upon their purchases of tangible personal property for resale in the form of tangible personal property if these are furnished to customers in connection with the rendition of information services.

Sales and Use Taxes—Change in Periods and Filing Dates

A return will be required to be filed for the period from April 1, 1953, through May 31, 1953. Thereafter, returns will be filed for the period ending on the last days of August, November, February and May. The returns will be due within twenty days after the expiration of the period covered by the return. Until the new period expiration dates, returns for the quarterly periods ending September 30, 1952, December 31, 1952, and March 31, 1953, are due within twenty days after the expiration of each of such periods.

Gross Receipts Tax—Exemptions

The exemptions outlined above, relating to sales and use taxes, are also incorporated in the gross receipts tax, similarly amended as of July 1, 1952.

The General Business and Financial Tax Law also exempts from the tax receipts of retirement systems under Section 200 of the Insurance Law; receipts of banks subject to Articles 3, 5, 6 and 7 of the Banking Law; receipts of cooperative organizations, including agricultural cooperatives; receipts from sales of real estate and rents derived from real estate; receipts of public utility corporations if these are taxed on gross income or receipts; wages and salaries of individuals.

Gross Receipts Tax—Dealers in Merchandise

The recent amendment to this law taxes dealers in merchandise either as a financial business or on the basis of gross receipts, depending upon the difference between the selling price and the cost of goods sold. If the spread is more than 3% and not in excess of 5%, the Comptroller may determine as a fact that the spread is in the nature of a commission and the tax is at the rate of 1/10 of all receipts received in New York as well as those allocable to New York. The determination of the Comptroller is final. If the difference between the selling price and the cost of goods sold is 3% or less, the dealer in merchandise pays a tax of 4/5 of 1% on the gross income. If the difference between the selling price and the cost of sales is in excess of 5%, the dealer in merchandise is required to pay a tax of 1/5 of 1% of the gross receipts.

For periods commencing July 1, 1952, persons carrying on a financial business will pay a tax of 4/5 of 1% on all gross income received in New York as well as gross income allocable to New York. The former rate was 2/5 of 1%.

Motor Vehicle Use Tax—Non-residents

This tax is assessed by New York City on residents. For the purposes of this tax, resident is defined in the regulations as "any person who maintains a residence, abode or place of business within the city." The term would in-

clude a person who maintains a residence, abode or place of business outside the city as well as one within the city. But, "a person who has a permanent place of abode outside the city and lives more than seven months of the calendar year outside the city shall not be deemed a resident."

A non-resident is not subject to the tax and so is not required to purchase a stamp in connection with the use of non-commercial vehicles. That is the rule even though the non-resident is employed or engaged in business in New York City and procured his license plates in New York City. But the non-resident would be subject to the tax if the car is registered in a trade name, a partnership name or corporate name of a person doing business in New York City.

Our attention has been called to the practice of adding a violation of this law by traffic policemen who issue tickets for traffic violations and who do not see the stamp on the wind shield. "No-fee" stamps are not issued to non-residents and such persons are required to produce proper evidence of their status when the question arises.

Estate Tax—Marital Deduction

This is one of the deductions from the gross estate in arriving at the net taxable estate. It was first introduced in the Internal Revenue Code (Section 812(e)) in 1948. New York State provides for a similar deduction, (Section 249-s). Generally the deduction may be as much as 50% of the gross estate less allowable debts and administration expenses (the adjusted gross estate) bequeathed to a spouse.

When this provision was first introduced into the law the problem was posed of how to write into a will a direction that would give the estate the maximum deduction. In a recent case¹ a decedent who died in October, 1951, had a provision in his will bequeathing to his widow 50% of the "gross estate

after deducting all items allowed by the Federal Tax Department as deductions so that the amount which is hereby devised to her shall equal in value to the maximum amount of the allowable marital deduction of which my estate may be entitled . . . before any provisions are made for the payment of any State and Federal inheritance or estate taxes chargeable against my estate."

The gross estate included property passing outside the will, a life insurance policy, a mortgage held jointly with the spouse and a residence held with the spouse in a tenancy by the entirety. These items were valued in the gross estate at \$31,000. Property passing under the will was valued at about \$500,000. In filing the estate tax return the executor took as a marital deduction one-half the value of all property included in the estate tax return (\$531,000) less allowable debts and administration expenses, contending that that amount was bequeathed to the widow. Residuary legatees claimed that the bequest to the widow should be diminished by the value of the property that passed to the widow outside of the will.

The Surrogate upheld the executor, stating that the testator intended to give the widow a general legacy, the amount of which was determined by a formula. It was obvious that the language used in the will was designed to achieve an estate tax advantage. Nevertheless the will contained no express language providing for a reduction of the bequest to the widow by the value of the property that passed to her outside the will.

Employment Termination Payment —Estate and Income Tax Aspects

Under an employment termination agreement an employee was to receive one year's salary, which could be spread over a two-year period at the employee's option. In the event of death before the completion of the payments,

¹ *Matter of Otto Reben, dec'd.*, Surrogates Court, Westchester County, 115 N.Y.S. 2nd. 228.

the balance still due would be paid to the widow or to the estate. The husband died before all the payments were made so the employer remitted the unpaid installments to the widow.

The payments to the wife were not included by the executrix in the estate tax return, but the Commissioner held them includable as an interest in property of the decedent at the time of his death. (I.R.C. Section 811(a); State Tax Law Section 249-r). The court held² that the obligation was recognized by the employer and was a recognition of the transfer from the dead to the living of a right to receive property. This was something the decedent owned at the date of his death.

In the joint income tax return filed for the decedent and his widow for the year in which the decedent died, the payments to the widow were excluded. The widow claimed that the payments were a gratuity under Section 22(b)(3) of the I.R.C. and therefore not taxable. The court held that the monthly payments were based upon the decedent's agreement and did not represent a gratuity. They were payments representing compensation for services rendered by the decedent, and come within the provisions of Section 126(a)(1), which require the inclusion of such amount as income by the person who acquires the right to receive it. The court did not mention the fact that the widow would be entitled to a deduction for the portion of the estate tax paid by reason of the inclusion of this income in the gross estate.

Under Section 358.1 of the State Income Tax Law, the payments to the widow are includable in the final decedent's return or, at the option of the executor, may be excluded provided the person entitled to receive the payments agrees to include them in the return filed by such person. Such person is not entitled to a deduction for the

amount of New York estate tax attributable to the payments.

If a non-resident beneficiary receives such payments and such non-resident would not ordinarily pay a New York income tax, the non-resident must file an agreement to pay the tax on such income and in addition file a bond to assure the payment of the tax. Since this is a tax primarily due from the decedent at the date of his death, the election in Section 358.1 cannot be used to defeat the tax. This would apply even though the recipient of the income would not be subject to tax because it had a non-taxable status such as a charitable trust.

Sales Tax—Freight and Transportation Charges

According to a ruling³ of the Special Deputy Comptroller, the sales tax will not be computed on freight charges included on a sales invoice if these are shown separately. This is so whether the seller prepays the freight or the purchaser pays it and receives an allowance for it when he pays the invoice. Freight charges are frequently included in a quoted list price, but they are deductible in computing the city sales tax if the charge appears on the invoice. If freight charges are absorbed in the selling price and not separately itemized the tax applies to the entire amount. Article 37 of the regulations makes an exception where the freight charges cover transportation from a seller's factory to his own warehouse.

Estate Tax—Insurance

Under the estate tax law the gross estate includes all insurance received by the executor under policies on the life of the decedent, and also amounts received by all other beneficiaries "to the extent that such amount is required to be included in the gross estate under the provisions for the taxing of estates

² *Estate of Arthur W. Davis v. Commissioner*, T.C. Memo Dkt. Nos. 32286, 36717, July 31, 1952.

³ Oct. 2, 1952.

contained in any Revenue Act of the United States applicable to the estate of the decedent." (Section 249(r) (8)(9), Tax Law).

In connection with insurance includable in the gross estate, Section 249-q(e) allows an exemption of \$100,000 for insurance payable to named beneficiaries. This is allowed in the first bracket of \$150,000 of the net taxable estate, which is taxable at 1%. The introduction of a marital deduction in 1950 made it necessary to amend the provision for exempting insurance⁴. Otherwise, the surviving spouse could get a double deduction if she received insurance proceeds which entitled the estate to the marital deduction.

The insurance exemption is computed as follows: The \$20,000 exemption for a spouse and the exemptions of \$5,000 each for lineal ancestors or descendants, etc., are added to any marital deduction allowable on account of property passing to a surviving spouse. The difference between this total and \$100,000 becomes the exemption for insurance payable to named beneficiaries.

Under Section 249-q of the Tax Law the widow's exemption may be reduced on account of the marital deduction. If that provision is applicable, it will not be included in the computation for determining the insurance exemption.

However if the insurance proceeds were included in the marital deduction, no exemption may be claimed for such insurance. If the surviving spouse receives more than 50% of the adjusted gross estate and this includes insurance, the marital deduction is arbitrarily considered as having been allowed first as to property other than life insurance payable to the spouse. In the latter event the insurance exemption will be allowed.

To illustrate, assume an adjusted gross estate of \$100,000 out of which property going to the widow amounts to \$70,000, of which \$40,000 is insur-

ance payable to her. The marital deduction is limited to \$50,000, one-half the adjusted gross estate. This is presumed to consist of \$30,000, representing property received by the widow other than insurance. Only the balance of \$20,000 would be insurance proceeds. That means that the remaining \$20,000 of the insurance proceeds would be exempt from estate tax under the \$100,000 insurance exemption provision.

If the entire insurance exemption has not been used up in the computation made above for the surviving spouse, there may be an additional insurance exemption for proceeds received by other named beneficiaries. This is computed by adding the total personal exemptions allowed on account of beneficiaries other than the spouse and the insurance exemption determined for insurance payable to the spouse. This is subtracted from \$100,000 and the balance becomes a further exemption for insurance. However, the exemption is reduced by the marital deduction or \$20,000, whichever is smaller. The purpose of this alternative reduction is to prevent the insurance exemption from being entirely wiped out for beneficiaries other than the spouse in those cases where there is a large marital deduction.

Estate Tax—Accrual and Payment; Discount and Interest

Under Section 249-z of the Tax Law the tax accrues as of the date of death and is payable without interest within 18 months of the date of death. The law permits a discount of 5% if payment of the tax is made within six months. Prepayment at a discount may be made within the first 15 months after the date of death, but the discount is reduced by one-half of 1% for each month after the expiration of six months.

If the estate tax is not paid within 18 months, Section 249-z provides that

(Continued on page 153)

⁴ Ch. 206, Laws of 1952, Section 249-q(e), effective May 1, 1952.

Accounting at the S. E. C.

Conducted by LOUIS H. RAPPAPORT, C.P.A.

Who Are An Accountant's Associates?

Some time ago the SEC announced that it had under consideration certain proposals to amend Regulation X-14 which is the Commission's regulation relating to solicitation of proxies. The regulation applies to all listed companies and to registered investment companies. The Commission has now determined that its proposed amendments, with certain modifications, should be adopted and has declared the amended regulation effective.

One of the provisions in the amended rules is of interest to accountants and when the proposal was first made, it was discussed in the March, 1952, issue of this magazine. When a proxy (which is subject to Regulation X-14) is solicited to be used at a meeting where action is to be taken with respect to the selection of auditors, certain requirements must be met. The SEC requirement in this connection is contained in Item 8 of the regulation which reads as follows:

If action is to be taken with respect to the selection of auditors, or if it is proposed that particular auditors shall be recommended for selection by any committee to select auditors for whom votes are to be cast, name the auditors and describe briefly any material relationship of such auditors or any of their associates with the issuer or any of its affiliates.

This item is unchanged from the previous version of the regulation, but the definition of an "associate" has been

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changed in a material respect. The term "associate" is now defined as follows:

Associate. The term "associate" used to indicate a relationship with any person, means (1) any corporation or organization (other than the issuer or a majority owned subsidiary of the issuer) of which such person is an officer or partner or is, directly or indirectly, the beneficial owner of 10 per cent or more of any class of equity securities, (2) any trust or other estate in which such person has a substantial beneficial interest or as to which such person serves as trustee or in a similar fiduciary capacity, and (3) any relative or spouse of such person, or any relative of such spouse, who has the same home as such person or who is a director or officer of the issuer or any of its parents or subsidiaries. (Emphasis supplied.)

Clause (3) in the above definition previously read "(3) any relative or spouse of such person having the same home as such person." As applied to an accountant, it appears that the term "associate" has been broadened to include any relative of the accountant or his wife who is a director or officer of the issuer or any of its affiliates, as well as relatives having the same home as the accountant or his wife.

Interest of an Accountant in His Client

One of the items in a registration statement under the 1933 Act deals with the relationship with the registrant of "experts" such as accountants, engineers and lawyers. This information is elicited in Item 26 which is not included in the prospectus, but is filed with the Commission as part of so-called Part II of the registration statement. The item in question reads as follows:

If any expert named in the registration statement as having prepared or certified any part thereof was employed for such

purposes on a contingent basis or, at the time of such preparation or certification or at any time thereafter, had a substantial interest in the registrant or any affiliate or was connected with the registrant or any affiliate as a promoter, underwriter, voting trustee, director, officer, employee or affiliate, furnish a brief statement of the nature of such contingent basis, interest or connection.

In response to this requirement, lawyers who prepare the registration document usually draft language to the effect that the "experts" (including the accountants) have no substantial interest in the company.

In Regulation S-X (which is the Commission's basic accounting regulation) the Commission has said that it will not recognize any accountant as independent with respect to any company in which he has any *financial* interest (Rule 2.01). The Commission's position as stated in Regulation S-X is

somewhat in conflict with the question it asks in the aforementioned Item 26 insofar as it relates to accountants, although the instruction to this item does direct attention to the requirements of Rule 2.01 of Regulation S-X.

Where, in response to the language of Item 26, companies have been stating that their accountants have no substantial interest in the company or any of its affiliates, the SEC has recently been directing their attention to Rule 2.01. Usually this results in an amendment having to be filed to the effect that the accountants have no *financial* interest—instead of no *substantial* interest. If this matter should come up in your practice you may want to anticipate this comment by the SEC. On the assumption that you have no financial interest in the company or its affiliates, you will tell your client to so state.

New York State Tax Forum

(Continued from page 151)

interest shall be charged at the rate of 10% per annum *from the date of decedent's death*. If an additional estate tax is assessed, interest at the rate of 10% is chargeable only on the additional tax and only from the date of final determination of the Federal estate tax. In the case of an additional estate tax, the interest charge will be entirely eliminated if payment of the tax is made within sixty days of the Federal determination of the tax. This provision was introduced in the 1952 legislature.⁵

Ordinarily an executor may not know within six months just what the estate tax will be. He may nevertheless obtain the 5% discount by making a temporary payment on the basis of his own estimate of the probable tax.

Interest at the rate of 10% per an-

num may be reduced to 6% by the surrogate. This will be done where because of necessary litigation or unavoidable delay the tax cannot be determined and paid within 18 months, but the reduction to 6% will be allowed only for the period of the necessary litigation or unavoidable delay. This situation has been litigated in the courts.⁶

An executor may obtain an extension of time for the payment of the tax for a period not exceeding four years from the date of death. For such an extended period, interest is charged at the rate of 6% even though the rate to the due date before the extension is 10%.

It should be noted that an executor may be surcharged for interest paid on estate taxes if the fault for non-payment is his.⁷

⁵ Chapter 19, Laws of 1952, Sec. 249(3)(1).

⁶ *Estate of R. W. Higbie*, Surrogate Ct., Queens Co., N. Y. L. J., 9/18/1940; *Estate of I. Lewis*, 183 Misc. 560, (1944).

⁷ *Estate of C. Rogers*, 258 N. Y. S. 534 (1932);

Estate of J. A. McCafferty, 264 N. Y. S. 38 (1933);

Estate of J. Both, Sur. Ct., Queens Co., N. Y. L. J., 9/16/44.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

New York Unemployment Insurance

Special Annual Contribution Reports for Certain Stockholder Employees

A member of the Society has called about a complaint which he says is quite general among accountants. It is his belief that the demands of the State with regard to the filing of information required of employers desiring to pay New York State unemployment insurance contributions on earnings of stockholder employees owning 25% or more of the voting stock of the corporation employer, are onerous and unnecessary. It was the member's thought that the information required by the state could be satisfied by a question printed on the form which could be answered very briefly. The Unemployment Insurance Division should take these suggestions into consideration for next year or sooner if it is at all possible to do so. The purpose of the special provisions relating to certain stockholder employees and students in regular attendance during the daytime in an institution of learning during all or any part of the school year or regular

vacation period, or in the case of dismissal wages which an employer is not legally obligated to pay, was to relieve an employer either in whole or in part from a tax liability that he would have had to pay otherwise to the Federal government, as additional Federal Unemployment Taxes.

If the employer in question is not subject on any part of his payroll to the Federal Unemployment Tax because he had not employed eight or more employees on each of twenty different days in twenty different weeks in the calendar year, then no tax need be paid to the New York State Unemployment Insurance Fund on the above mentioned wage or salary payments.

If the employer is subject to the Federal Unemployment Tax on his payroll then contributions on such wage and salary payments must be made to the state. If the employer's state rate is less than 2.7% the reduced rate also applies on the remuneration in question. The credit taken on the Federal Unemployment Tax Return following the close of the calendar year when it must be filed, is for a full 2.7%, thus saving the employer the difference between having to pay the Federal government a full 2.7% on such payments to employees if they were not taxable by the state, and the reduced New York State Tax rate.

Like many of the other complicated reports and computations that taxpay-ers and their accountants are subjected to regularly, more often than not, they are the result of an attempt either to give a taxpayer some tax relief, and to remedy an inequity in the law as it was or to close some tax saving device or so-called loop-hole in the tax statute. The complication flowing from the New York law was designed primarily

SAMUEL S. RESS has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting, on Labor and Management, and on State Taxation.

to save New York employers some money and secondarily to channel the revenue towards the New York Unemployment Insurance fund and away from the Federal treasury.

Successor Employers

Two decisions by the Appellate Division of the Supreme Court were handed down recently regarding the right of an alleged successor employer to Contribution Rate Credits. In both cases the employer's claims were disallowed.

In *Matter of the Application for Contribution Rate Credits or a refund made by Tru-Stitch Moccasin Corporation* (Appeal Board Case #29,272-51, decided by the Appellate Division, Third Judicial Department, on November 17, 1952) the court upheld the initial determination that appellant was not entitled to a tax credit for the 1947 tax credit year upon the ground that its predecessor, a co-partnership, did not transfer all of its assets to the appellant. The precise question before the tribunal was: Did the appellant, in August 1946, acquire from the partnership transferor all or substantially all of its assets upon the partnership's discontinuance of operations, so as to constitute the appellant a "qualified employer" as defined by Section 577, subdivision 1, of the statute as it read at that time?

The court found that upon the reorganization of the former partnership business into corporate form, the major portion of its assets was transferred to the appellant and the remainder, consisting principally of its smaller factory and plant at another location, was transferred to another corporation which continued its operation. This factory and plant, although a minor part of the partnership's total assets, was so substantial as to support a finding by the Appeal Board that the appellant had not as a fact acquired "all or substantially all" of the co-partnership assets within the meaning of the statute.

In such a situation under the present statute both successors could make an application jointly as successor employers and thus become qualified for a possible lower state unemployment insurance rate.

Another way of handling the situation would be for the predecessor employer to sell its smaller plant to a purchaser and then at a later date to transfer all of its assets as they are at that later date to the firm that it wishes to become its successor for unemployment insurance purposes.

In *Matter of the Application for a Refund of Contributions under Article 18 of the Labor Law made by Thomas S. Lee Enterprises, Inc., successor by merger to General Teleradio, Inc. (formerly known as Bamberger Broadcasting Service, Inc.), Appellant*, the court sustained the decision of the Unemployment Insurance Appeal Board denying the employer's application for a refund of \$10,842.12, paid during the third and fourth quarters of 1948. The statute involved reads:

"1. Limitation. 'Wages' means all remuneration paid, except that such term does not include remuneration paid to an employee by an employer after three thousand dollars have been paid to such employee by such employer with respect to employment during any calendar year. The term 'employment' includes for the purposes of this subdivision services constituting employment under any unemployment compensation law of another state or the United States.

"2. Joint consideration. If an employer has acquired all or substantially all the assets of another employer liable for contributions under this article and has assumed liability for unpaid contributions, if any, due from such other employer, remuneration paid by both employers shall be deemed paid by a single employer for the purposes of this section."

In the case at bar there had been a finding that between 84 per cent and 86 per cent of the assets had been transferred. There had also been a finding that the transfer involved certain functions and the assets related to those functions. The Appeal Board had concluded that "all or substantially all" of

(Continued on page 158)

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Tax Return Instruction Letters

In the October, 1951, column a copy of a tax return instruction sheet was reproduced and the advantages of the use of such forms were pointed out. However, the form demonstrated was of a type that required a different form of instruction sheet for each type of tax return. A practitioner sent us a copy of two all-embracing instruction sheets, the first (Exhibit I) covering Federal returns and the second (Exhibit II) covering State and City returns.

Reproducing New York State Tax Returns

The Commissioners of the New York State Tax Department have ruled *against* acceptance of photographic reproductions of tax returns. This is contrary to the position of the Commissioner of Internal Revenue, as referred to in last month's column. They will however accept returns on photographic masters, which are originals, for reproduction.

The latter procedure permits an accountant to handwrite or typewrite on the photographic master and then reproduce as many copies as needed. However, the master copy is the one

which must be mailed to the Tax department. A substantial typing economy can be realized if the handwritten copy is reproduced. Even if the original is typed, reproduction of the other copies required has the advantage of speedier preparation and better copies. The problems of aligning two or three tax blanks in a typewriter, and of correcting typographical errors, which are large time consumers, can be overcome by mechanical reproduction.

Accountants' Signatures on Tax Returns

A special ruling of the Treasury Department (Letter of Deputy Commissioner McLarney, July 2, 1952) holds that an accountant who happens to be an officer of a corporation may not sign both as an officer and as an independent accountant. Returns improperly signed by the accountant become invalid and problems may thereby be created.

Mechanics for Reporting Federal Income Tax Changes to New York State

This problem has been discussed previously, and the importance of establishing a definite procedure to assure that changes in Federal income taxes reported are communicated to the New York State Tax Department was stressed.

Several revisions in the State's requirements have recently been made. They are the following:

1. Effective December 1, 1952, tax payers must use Form IT-115 for notifications to the Department.

MAX BLOCK, C.P.A. (N.Y., Pa.) is a director of the New York State Society of Certified Public Accountants and has been the Chairman of the Society's Committee on Administration of Accountants' Practice. He is a member of the firm of Anchin, Block & Anchin.

Office and Staff Management

Name and Address of Accounting Firm	Date: Client:
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FEDERAL TAX ENCLOSURE

TAX

<input type="checkbox"/> 195 Income	TOTAL AMOUNT \$.....
<input type="checkbox"/> 195 Estimated Income	PAY NOW
<input type="checkbox"/> 195 Unemployment Insurance	BALANCE
<input type="checkbox"/> Qtr 195 Withholding	(IF ANY, SEE BELOW)
<input type="checkbox"/>	REFUND DUE YOU.....

STATE TAX

<input type="checkbox"/> 195 Income	TOTAL AMOUNT \$.....
<input type="checkbox"/> 195 Franchise	PAY NOW
<input type="checkbox"/> Qtr 195 Disability Ins.	BALANCE
<input type="checkbox"/> Qtr 195 Unemployment Ins.	(IF ANY, SEE BELOW)
<input type="checkbox"/>	REFUND DUE YOU.....

DUE DATE: March 15, 1955
 195

PAYABLE TO: Collector of Internal Revenue
 MAIL TO: 110 East 45th Street, N.Y.C.
 Custom House, N.Y.C.

SIGN PAGE 1.....

PAY BALANCE (IF ANY), AS FOLLOWS:

June 15.....
 Sept. 15.....
 Dec. 15.....
 Jan. 15.....

DUE DATE: 195
 PAYABLE TO: State Tax Commission, Albany, N.Y.
 State Unemployment Ins. Fund, Albany, N.Y.
 State Insurance Fund, New York, N.Y.
 City Collector, New York, N.Y.

SIGN PAGE:
 PAY BALANCE (IF ANY), AS FOLLOWS:
 July 15.....
 Oct. 15.....
 Jan. 15.....

AFFIX SEAL:

AFFIX SEAL:

Exhibit 1.

Exhibit 2.

2. Where additional State tax is due payment must accompany the form.

3. The changes in the Federal income liability may be explained on or with the form instead of submitting a copy of the Treasury Department report, if desired.

4. The definition of a final determination has been revised to include a waiver filed under Section 272(d) of the Internal Revenue Code, where no 90-day deficiency notice is issued.

Salary Control for C.P.A.'s

The last vestige of salary stabilization control over C.P.A. staff members has been lifted. Interpretation #15 has finally been revised, largely as a result of the efforts of the American Institute of Accountants, whereby the geographic jurisdiction is no longer an obstacle for the complete elimination of salary control.



Payroll Tax Notes

(Continued from page 155)

the assets had not been transferred. The court stated in its decision affirming the denial of the refund claim:

"We find nothing in the decision that requires reversal as a matter of law. The Legislature in the enactment of the statute under consideration fixed no arbitrary percentages upon which to base a determination. It necessarily follows that the issue of whether all or substantially all of the assets of a business have been transferred falls largely within the realm of fact. Where, under all the circumstances, there is room for a divergence of opinion the administrative determination must be accepted.

"No purely mechanical formula for the solution of such an issue can be found except by legislative fiat. Under the circumstances we cannot say that the determination of the Board was unreasonable or arbitrary either as a matter of fact or law."

Joint Employment

In another decision of the Appellate Division of the Supreme Court of New York, *Matter of Liability for Unemployment Insurance Contributions . . . of David Berg, Appellant*, decided November 17, 1952, it was held that a lawyer who employs three stenographers in his own law office and has an arrangement with three other law offices by which all together use the services of a telephone operator, each paying one-fourth of her salary, through one of the other lawyers, the appellant is an employer subject to

the unemployment insurance law. The court held that the decision in *Matter of Fulton Ship Operators P & I Service Inc.* (273 App. Div. 614) is not controlling under the facts here. The decisions in the *Matter of United Traction Co.* (280 App. Div. 291) and *Matter of Miller* (260 App. Div. 888) were held to apply wherein the employee in question was deemed the employee of all the participants in the arrangement for employment.

Right to a Hearing by an Employer

The Appeal Board has held in case #33,219-52, that Claimant's last employer who was not a base-year employer, was entitled to a hearing on an initial determination holding claimant had left his employment with good cause. In the present case the claimant had not worked for the appealing employer during his base period and benefits paid would not be charged to the contesting employer's account.

Question of Weeks of Employment

The period while a seaman is hospitalized and with respect to which the employer is obligated to continue his wages represents weeks of employment for determining the unemployed claimant's right to benefits, pursuant to Section 527 of the Unemployment Insurance Law. (Case #3065-52R.)

The Excess Profits Tax Exchange

Conducted by DAVID ZACK, C.P.A.

THIS department is a clearing house for questions, problems, comments and rulings regarding Excess Profits Taxes. We are especially interested in special and informal Bureau rulings on Excess Profits Taxes. All items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified Public
Accountant
677 Fifth Avenue
New York 22, N. Y.

Ceiling Rates For New Corporations

Samuel A. Dyckman, C.P.A., points out a proposed amendment to the Excess Profits Tax Regulations which we hope will be the last word on this most practical subject.

"In the February and July, 1952, issues, you discussed the applicability of the ceiling rates under Sec. 430 (e)

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Mr. Zack has written on tax matters for various publications. He is a partner in the firm of David Berdon & Co., Certified Public Accountants.

to acquiring corporations. In the earlier issue, I had submitted my analysis as to why it appeared to me from a study of the statute that, for purposes of the ceiling rates, newly incorporated partnerships did not have to tack on the existence of its nonincorporated "components."

"The Bureau initially took an opposing position in an informal Bureau ruling published in your columns in the July issue. It is interesting to note that in its proposed amendments to regulations published in the Federal Register on December 13, 1952, the Bureau has now taken the reverse position. The proposed regulation, Sec. 40.430-2 (e) 5 (ii), states:

"The provisions of section 430(e)(2)-(B)(i) and of subparagraph (i) of this paragraph are applicable only if the party to the transaction with the taxpayer was a corporation. They do not apply, for example, where such party was an individual or a partnership. Thus, if an individual who has been operating a certain business as a sole proprietorship incorporates such business and transfers all the assets of the business to a newly formed corporation in a transaction which qualifies as a section 112(b)(5) transaction, the newly formed corporation will not be deemed to have been in existence during the prior period when the individual was conducting the business as a sole proprietorship nor will the corporation be deemed to have had taxable years during such prior period."

Tax Savings On Borrowed Capital

Maurice Burstein, C.P.A., submits a very interesting study of the tax benefits flowing from borrowed money under the current excess profits tax laws.

"Various comments have appeared on the subject of tax advantages to be gained by a corporation in borrowing. These advantages were made possible

by the Excess Profits Tax Act of 1950, and even more so, by the Revenue Act of 1951.

"Under the Excess Profits Tax Act of 1950, a corporation in the 77% bracket actually *gained* by borrowing money. When it paid interest at the rate of 1% it gained \$2.245 on each \$100 it borrowed, and on each additional 1% of interest it paid, the gain was reduced by \$.455 on each \$100 it borrowed. The break-even point was a 5.934% interest rate.

"Under the Revenue Act of 1951, the tax benefits resulting from borrowing money increased for a corporation paying 30% Excess Profits Tax. On the first 1% interest it paid, it gained \$2.295 on each \$100 it borrowed, and on each additional 1% interest it paid, the gain was reduced by \$.405 per \$100 borrowed. The break-even point is now a 6.666% interest rate.

"However, should the corporation be in the 18% Excess Profits Tax ceiling bracket (when the Excess Profits Credit is less than 40% of Excess Profits Net Income), there is NO gain in borrowing, but the corporation still gets the benefit of lower cost of interest. Each 1% interest costs the corporation only \$.435 per \$100 borrowed, reducing therefore the interest cost by \$.565 on each \$100 borrowed.

"New corporations (with a net income of more than \$25,000, but an Excess Profits net income of \$300,000 or less) are also offered opportunities for saving on borrowed money by the Revenue Act of 1951 because of their choice of Excess Profits Tax ceilings of 5%, 8%, 11% and 14% in their first two years, third year, fourth year and fifth year respectively, instead of the 18% Excess Profits Tax ceiling applicable to old corporations. After the fifth year of its existence, the corporation loses its status as a new corporation and falls into the class of an old corporation paying 18% Excess Profits Tax ceiling."

"To summarize, under the Revenue Act of 1951

- "a) When a corporation pays 30% Excess Profits Tax (with Excess Profits Credit of MORE than 40% of its Excess Profits Net Income):
 - 1) The cost of borrowing money at 6 2/3% rate of interest is offset by a tax saving equivalent to the interest cost, i.e., break-even point.
 - 2) The borrowing of money at 1% rate of interest results in a gain of \$2.295 for each \$100 borrowed.
 - 3) In borrowing money at a rate of interest higher than 1%, the gain is reduced by \$.405 per \$100 borrowed at an additional 1% rate of interest.
 - 4) In borrowing money at a rate of interest higher than 6 2/3%, the cost of borrowing money is reduced by \$.595 for each \$100 borrowed at an additional 1% rate of interest.

"b) A corporation paying 18% Excess Profits Tax ceiling (with an Excess Profits Credit of 40% or less of its Excess Profits net income) —or A new corporation after its fifth year (with a net income of more than \$25,000, but Excess Profits net income of \$300,000 or less)

- 1) SAVES on Cost of Interest .565% of each 1% of interest it pays.

"c) A new corporation (with a net income of MORE than \$25,000 but an Excess Profits net income of \$300,000 or LESS)

- 1) SAVES on Cost of Interest it pays during:

First & second year	.5325% of each 1% it pays
Third year	.54% of each 1% it pays
Fourth year	.5475% of each 1% it pays
Fifth year	.555% of each 1% it pays"

OFFICIAL DECISIONS and RELEASES

ACCOUNTING RESEARCH BULLETINS

Issued by the

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No. 11 (Revised) November, 1952

Accounting for Stock Dividends and Stock Split-Ups

This bulletin supersedes Accounting Research Bulletin No. 11, "Corporate Accounting for Ordinary Stock Dividends," issued in September, 1941.

1. The term *stock dividend*, as used in this bulletin, refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business.

2. The term *stock split-up*, as used in this bulletin, refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares.

3. This bulletin is not concerned with the accounting for a distribution or issuance to shareholders of (a) shares of another corporation theretofore held as an investment, or (b) shares of a different class, or (c) rights to subscribe for additional shares, or (d) shares of the same class in cases where each shareholder is given an election to receive cash or shares.

4. The discussion of accounting for stock dividends and split-ups that follows is divided into two parts. The first deals with the problems of the recipient. The second deals with the problems of the issuer.

As to the Recipient

5. One of the basic problems of accounting is that of income determination. Complete

discussion of this problem is obviously beyond the scope of this bulletin. Basically, income is a realized gain and in accounting is recognized, recorded, and stated in accordance with certain principles as to time and amount.

6. In applying the principles of income determination to the accounts of the shareholder of a corporation, it is generally agreed that the problem of determining his income is distinct from the problem of income determination by the corporation itself. The income of the corporation is determined as that of a separate entity without regard to the equity of the respective shareholders in such income. Under conventional accounting concepts, the shareholder has no income solely as a result of the fact that the corporation has income; the increase in his equity through undistributed earnings is no more than potential income to him. It is true that income earned by the corporation may result in an enhancement in the market value of the shares, but until there is a distribution, division, or severance of corporate assets, the shareholder has no income. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize upon without parting with some of his proportionate interest in the corporation.

7. The foregoing are important points to be considered in any discussion of the accounting procedures to be followed by the recipient of a stock dividend or split-up since many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the *separate entity* concept of corporation accounting.

8. The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known.¹ The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in *Eisner v. Macomber*, 252 U. S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

¹ See, for instance, Freeman, "Stock Dividends and the New York Stock Exchange," *American Economic Review*, December, 1931 (pro), and Whitaker, "Stock Dividends, Investment Trusts, and the Exchange," *American Economic Review*, June, 1931 (con).

"A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased . . . the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones."

9. Since a shareholder's interest in the corporation remains unchanged by a stock dividend or split-up except as to the number of share units constituting such interest, the cost of the shares previously held should be allocated equitably to the total shares held after receipt of the stock dividend or split-up. When any shares are later disposed of, a gain or loss should be determined on the basis of the adjusted cost per share.

As to the Issuer

Stock Dividends

10. As has been previously stated, a stock dividend does not, in fact, give rise to any change whatsoever in either the corporation's assets or its respective shareholders' proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed purpose of the transaction and its characterization as a "dividend" in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains substantially unchanged. The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.

11. Where the number of additional shares issued as a stock dividend is so great that it has, or may reasonably be expected to have,

the effect of materially reducing the share market value, the committee believes that the implications and possible constructions discussed in the preceding paragraph are not likely to exist and that the transaction clearly partakes of the nature of a stock split-up as defined in paragraph 2. Consequently, the committee considers that under such circumstances there is no need to capitalize earned surplus, other than to the extent occasioned by legal requirements. It recommends, however, that in such instances every effort be made to avoid the use of the word "dividend" in related corporate resolutions, notices, and announcements and that, in those cases where because of legal requirements this cannot be done, the transaction be described, for example, as a "split-up effected in the form of a dividend."

12. In cases of closely-held companies, it is to be presumed that the intimate knowledge of the corporations' affairs possessed by their shareholders would preclude any such implications and possible constructions as are referred to in paragraph 10. In such cases, the committee believes that considerations of public policy do not arise and that there is no need to capitalize earned surplus other than to meet legal requirements.

13. Obviously, the point at which the relative size of the additional shares issued becomes large enough to materially influence the unit market price of the stock will vary with individual companies and under differing market conditions and, hence, no single percentage can be laid down as a standard for determining when capitalization of earned surplus in excess of legal requirements is called for and when it is not. However, on the basis of a review of market action in the case of shares of a number of companies having relatively recent stock distributions, it would appear that there would be few instances involving the issuance of additional shares of less than, say, 20% or 25% of the number previously outstanding where the effect would not be such as to call for the procedure referred to in paragraph 10.

14. The corporate accounting recommended in paragraph 10 will in many cases, probably the majority, result in the capitalization of earned surplus in an amount in excess of that called for by the laws of the state of incorporation; such laws generally require the capitalization only of the par value of the shares issued, or, in the case of shares without par value, an amount usually within the discretion of the board of directors. However, these legal requirements are, in effect, minimum requirements and do not prevent the capitalization of a larger amount per share.

Stock Split-Ups

15. Earlier in this bulletin a stock split-up was defined as being confined to transactions

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involving the issuance of shares, without consideration moving to the corporation, for the purpose of effecting a reduction in the unit market price of shares of the class issued and, thus, of obtaining wider distribution and improved marketability of the shares. Where this is clearly the intent, no transfer from earned surplus to capital surplus or capital stock account is called for, other than to the extent occasioned by legal requirements. It is believed, however, that few cases will arise where the aforementioned purpose can be accomplished through an issuance of shares which is less than, say, 20% or 25% of the previously outstanding shares.

16. The committee believes that the corporation's representations to its shareholders as to the nature of the issuance is one of the principal considerations in determining whether it should be recorded as a stock dividend or a split-up. Nevertheless, it believes that the issuance of new shares in ratios of less than, say, 20% or 25% of the previously outstanding shares, or the frequent recurrence of issuances of shares, would destroy the presumption that transactions represented to be split-ups should be recorded as split-ups.

The statement entitled "Accounting for Stock Dividends and Stock Split-Ups" was adopted by the assenting votes of nineteen members of the committee, of whom two, Messrs. Knight and Calkins, assented with qualification. One member, Mr. Wilcox, dissented.

Mr. Knight assented with the qualification that he believes the bulletin should recognize the propriety of treating as income stock dividends received by a parent from a subsidiary. He believes the bulletin should have retained from the original Bulletin No. 11 the statement, "It is recognized that this rule, under which the stockholder has no income until there is a distribution, division, or severance, may require modification in some cases, or that there may be exceptions to it, as, for instance, in the case of a parent company with respect to its subsidiaries. . . ."

Mr. Calkins approves part one of the bulletin, but believes part two is inconsistent therewith in that the former concludes that a stock dividend is not income to the recipient while the latter suggests accounting procedures by the issuer based on the assumption that the shareholder may think otherwise. He believes it is inappropriate for the corporate entity to base its accounting on considerations of possible shareholder reactions. He also believes that part two deals with matters of corporate policy rather than accounting principles and that the purpose sought to be served could be more effectively accomplished by appropriate notices to shareholders at the time of the issuance of additional shares.

Mr. Wilcox dissents from the recommendations in this bulletin both as to the recipient and the issuer. He believes that, with proper safeguards, stock dividends should be regarded as marking the point at which corporate income is to be recognized by shareholders, and denies that the arguments favoring this view are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation. He believes that the arguments regarding severance and maintenance of proportionate interest are unsound, and cannot logically be invoked as they are in this bulletin, since they are widely ignored with respect to distributions of securities other than common stock dividends. Mr. Wilcox believes the recommendations as to the issuer are inconsistent with the rest of the bulletin, involve arbitrary distinctions, hamper or discourage desirable corporate actions, result in meaningless segregation in the proprietorship section of balance sheets, and serve no informative purpose which cannot be better served by explanatory disclosures. He therefore also dissents from the omission of requirements for information and disclosures which were contained in the original Bulletin No. 11 issued in September, 1941.

No. 42

November, 1952

Emergency Facilities—Depreciation, Amortization, and Income Taxes

Certificates of Necessity

1. Section 124A of the Internal Revenue Code, which was added by the Revenue Act of 1950, provides for the issuance of certificates of necessity under which all or part of the cost of so-called *emergency facilities* may be amortized over a period of 60 months for income tax purposes. In many cases, the amounts involved are material, and companies are faced with the problem of deciding whether to adopt the 60-month period over which the portions of the cost of the facilities covered by certificates of necessity may be amortized for income tax purposes as the period over which they are to be depreciated in the accounts.

2. Thinking on this question apparently has become confused because many so-called *percentage certificates* have been issued covering less than the entire cost of the facility. This fact, together with the fact that the probable economic usefulness of the facility after the close of the five-year amortization period is considered by the certifying authority in determining the percentage covered by these certificates, has led many to believe that the percentage used represents the Government's conclusion as to the proportion of the

cost of the facility that is not expected to have usefulness at the end of five years.

3. In some cases, it is apparent that the probable lack of economic usefulness of the facility after the close of the amortization period must constitute the principal if not the sole basis for determining the percentage to be included in the certificate. However, it must be recognized that the certifying authority has acted under orders to give consideration also to a variety of other factors to the end that the amount certified may be the minimum amount necessary to secure expansion of industrial capacity in the interest of national defense during the emergency period. Among the factors required to be considered in the issuance of these certificates, in addition to loss of useful value, are (a) character of business, (b) extent of risk assumed (including the amount and source of capital employed, and the potentiality of recovering capital or retiring debt through tax savings or pricing), (c) assistance to small business and promotion of competition, (d) compliance with Government policies (e.g., dispersal for security), and (e) other types of incentives provided by Government, such as direct Government loans, guarantees and contractual arrangements.

Depreciation Considerations

4. The argument has been advanced from time to time that, since the portion of the cost of properties covered by certificates of necessity is amortized over a five-year period for income tax purposes, it is necessary to follow the same procedure in the accounts. Sound financial accounting procedures do not necessarily coincide with the rules as to what shall be included in "gross income," or allowed as a deduction therefrom, in arriving at taxable net income. It is well recognized that such rules should not be followed for financial accounting purposes if they do not conform to generally accepted accounting principles. However, where the results obtained from following income tax procedures do not materially differ from those obtained where generally accepted accounting principles are followed, there are practical advantages in keeping the accounts in agreement with the income tax returns.

5. The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, "a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less

salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation."¹

6. The committee is of the opinion that from an accounting standpoint there is nothing inherent in the nature of emergency facilities which requires the depreciation or amortization of their cost for financial accounting purposes over either a shorter or a longer period than would be proper if no certificate of necessity had been issued. Estimates of the probable useful life of a facility by those best informed in the matter may indicate either a shorter or a longer life than the statutory 60-month period over which the certified portion of its cost is deductible for income tax purposes.

7. In determining the proper amount of annual depreciation with respect to emergency facilities for financial accounting purposes, it must be recognized that a great many of these facilities are being acquired primarily for what they can produce during the emergency period. To whatever extent it is reasonable to expect the useful economic life of a facility to end with the close of the amortization period the cost of the facility is a proper cost of operation during that period.

8. In determining the prospective usefulness of such facilities it will be necessary to consider their adaptability to post-emergency use, the effect of their use upon economic utilization of other facilities, the possibility of excessive costs due to expedited construction or emergency conditions, and the fact that no deductions for depreciation of the certified portion will be allowable for income tax purposes in the post-amortization years if the company elects to claim the amortization deduction. The purposes for which emergency facilities are acquired in a great many cases are such as to leave major uncertainties as to the extent of their use during the amortization period and as to their subsequent usefulness—uncertainties which are not normally encountered in the acquisition and use of operating facilities.

9. Consideration of these factors, the committee believes, will in many cases result in the determination of depreciation charges during the amortization period in excess of the depreciation that would be appropriate if these factors were not involved. Frequently they will be so compelling as to indicate the need for recording depreciation of the cost of emergency facilities in the accounts in conformity with the amortization deductions allowable for income tax purposes. However, the committee believes that when the amount allowed as amortization for income tax purposes is materially different from the amount of the estimated depreciation, the

¹ Accounting Research Bulletins Nos. 16, 20, and 22.

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latter should be used for financial accounting purposes.

10. In some cases, certificates of necessity cover facilities which the owner expects to use after the emergency period in lieu of older facilities. As a result the older facilities may become unproductive and obsolete before they are fully depreciated on the basis of their previously expected life. In such situations, the committee believes depreciation charges to income should be determined in relation to the total properties, to the end that sound depreciation accounting may be applied to the property accounts as a whole.

Recognition of Income Tax Effects

11. In those cases in which the amount of depreciation charged in the accounts on that portion of the cost of the facilities for which certificates of necessity have been obtained is materially less than the amount of amortization deducted for income tax purposes, the amount of income taxes payable annually during the amortization period may be significantly less than it would be on the basis of the income reflected in the financial statements. In such cases, after the close of the amortization period the income taxes will exceed the amount that would be appropriate on the basis of the income reported in the statements. Accordingly, the committee believes that during the amortization period, where this difference is material, a charge should be made in the income statement to recognize the income tax to be paid in the future on the amount by which amortization for income tax purposes exceeds the depreciation that would be allowable if certificates of necessity had not been issued. The amount of the charge should be equal to the estimated amount by which the income tax expected to be payable after the amortization period exceeds what would be so expected if amortization had not been claimed for income tax purposes in the amortization period. The estimated amount should be based upon normal and surtax rates in effect during the

period covered by the income statement with such changes therein as can be reasonably anticipated at the time the estimate is made.

12. In accounting for this deferment of income taxes, the committee believes it desirable to treat the charge as being for additional income taxes. The related credit in such cases would properly be made to an account for deferred income taxes. Under this method, during the life of the facility following the amortization period the annual charges for income taxes will be reduced by charging to the account for deferred income taxes that part of the income tax in excess of what would have been payable had the amortization deduction not been claimed for income tax purposes in the amortization period. By this procedure the net income will more nearly reflect the results of a proper matching of costs and revenues.

13. There are those who similarly recognize the necessity for giving effect to the amount of the deferred income taxes but who believe this should be accomplished by making a charge in the income account for additional amortization or depreciation. They would carry the related credit to an accumulated amortization or depreciation account as a practical means of recognizing the loss of future deductibility of the cost of the facility for income tax purposes. If this procedure is followed the annual charges for depreciation will be correspondingly reduced throughout the useful life of the facility following the amortization period. Although this procedure will result in the same amount of net income as the procedure outlined in paragraph 12, and therefore may be considered as acceptable, the committee regards the paragraph 12 procedure as preferable. In any circumstances, there should be disclosure of the procedures followed.

The statement entitled "Emergency Facilities—Depreciation, Amortization, and Income Taxes" was adopted unanimously by the twenty members of the committee.

NOTES

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)

2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

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3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)

COMMITTEE ON ACCOUNTING PROCEDURE (1952-1953)

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Director of Research



New Section 94, Regulations of the Commissioner of Education

The following is the text of Section 94 of the Regulations of the Commissioner of Education, adopted by the Board of Regents on December 19, 1952, and effective as of that date.

ARTICLE XI CERTIFIED PUBLIC ACCOUNTANCY

§94 Unprofessional conduct and unprofessional advertising

1. A certified public accountant of this State shall be guilty of unprofessional conduct if he

a Is guilty of fraud, deceit or gross negligence in the public practice of accountancy;

b Commits or engages in acts or conduct, whether or not in or connected with the public practice of accountancy, which evidence moral unfitness for the public practice of accountancy;

c Allows any person other than a partner or a duly authorized employee to engage in the public practice of accountancy in his or his firm's name, this rule not being intended to apply to the use of firm names by successors;

d Issues in his name or permits his firm to issue in its name a report purporting to be based upon an examination by him or his firm of financial statements, when any material portion of the examination of such statements and related records, including the examination of any material financial statements or data incorporated in the financial statements reported upon, has not been made either (1) by him or a partner or an employee or (2) with his or his firm's approval, by a certified public accountant of a state, terri-

tory or possession of the United States or the District of Columbia, or the holder of an equivalent certificate issued by the proper authorities of another country, or a firm partially composed of such certified public accountants or holders of equivalent certificates;

e Permits his or his firm's name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he or his firm vouches for the accuracy of the forecast;

f Expresses an opinion or knowingly permits his firm to express an opinion on financial statements of an enterprise financed in whole or in part by public distribution of securities, or on financial statements for use as a basis for credit, if he, a partner in his firm, or a member of his immediate family, or a member of his partner's immediate family, owns or is committed to acquire a substantial financial interest in the enterprise, or if he, or a partner in his firm, is or during the period covered by the examination has been a director, officer, or employee of the enterprise, unless such interest or relationship is disclosed in the report;

g Discloses information acquired in the course of a professional engagement except with the permission of his client or as required by law;

h Is an officer, director, stockholder, representative or agent of any corporation engaged in the public practice of accountancy;

i Directly or indirectly solicits clients by circular, advertisements or personal communication or interview not warranted by existing personal relations;

j Directly or indirectly pays or allows or agrees to pay or allow a commission, broker-

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age or other participation in the fees or profits of his professional services to a person not engaged in the public practice of accountancy, or accepts, directly or indirectly, from a person not engaged in the public practice of accountancy, any commission, brokerage, or other participation in professional work or commercial business referred to others as an incident to his services to clients.

2. A certified public accountant of the State shall be guilty of unprofessional advertising if he advertises his professional attainments or services in any manner, except within the following limitations and restrictions:

a. The publication, issuance or use of a card, issued in connection with the opening of an office for the public practice of accountancy or a change in address, personnel or firm name, and restricted to an announcement of the name, title (C.P.A. member of

a state society, or other professional affiliations or designations), class of service, the address of the person or firm, which shall not exceed two columns in width and three inches in depth if appearing in a newspaper, or one-quarter of a page if appearing in a magazine or similar publication

b. Listings in directories, restricted to the name, title, address and telephone number of the person or firm, not appearing in bold type, boxes, or other style which differentiates them from the majority of the other names in the same list

c. Listing on the doors or windows of the office, or on the directory of the building in which the office is located, of the name of a person or firm, the names of the partners in the firm, the title, and other offices maintained by the person or firm.

Approved December 19, 1952.



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The Board of Directors of the Society has authorized the Committee on Publications to conduct a prize essay contest among seniors and graduate students majoring in accountancy, duly enrolled in the colleges of New York State. The article may cover any topic in the field of accounting and/or auditing.

Prizes in the amount of \$100 for the best article and \$50 for the second best article are offered. In addition, the two winners and any others submitting papers worthy of honorable mention will receive a one-year subscription to *The New York Certified Public Accountant*.

The General Rules of the Contest are as follows:

All papers shall be original, and the manuscript shall be typed in duplicate on 8½ x 11 stationery on one side, double or triple space typing, and shall not be more than 6,000 words in length. Each contestant shall indicate the exact number of words in his paper at the end thereof.

★

The name of the individual submitting the paper shall not appear thereon, nor should there be any other means of identifying the manuscript, which should be accompanied by a covering letter giving the contestant's name and address. When submitted to the judges, each manuscript will be given a key number for identification.

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Manuscripts should be forwarded to The Managing Editor of *The New York Certified Public Accountant*, 677 Fifth Avenue, New York 22, N. Y., on or before May 15, 1953. Awards will be announced as soon thereafter as possible.

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All papers submitted shall become the property of the New York State Society of Certified Public Accountants and shall be available for publication in *The New York Certified Public Accountant*. The decision of the judges shall be final as to what papers, if any, may be entitled to prizes.

